

103
U.S. FOREIGN POLICY ON PRIVATIZATION:
RESULTS FOR SMALL BUSINESS

Y 4. SM 1:103-81

U.S. Foreign Policy on Privatization...ARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

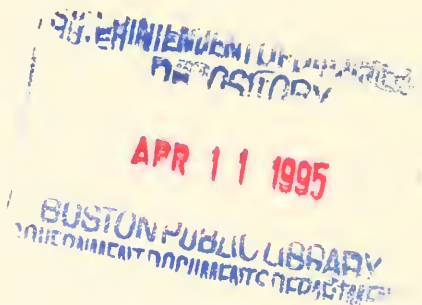
ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, MAY 12, 1994

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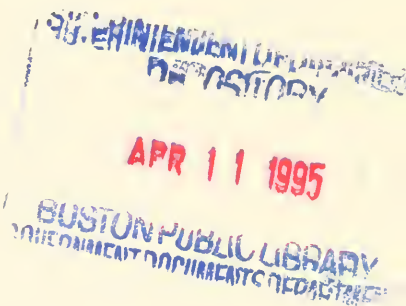
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U.S. FOREIGN POLICY ON PRIVATIZATION: RESULTS FOR SMALL BUSINESS

THURSDAY, MAY 12, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order. Our Small Business Committee is meeting this morning to continue its examination of the global privatization process and its implications for the business community and economic equity in the societies involved.

On April 14, our committee heard from witnesses representing practitioners, academics, and consultants.

This morning we welcome administration witnesses as we focus specifically on U.S. privatization policy: What our goals are and how we implement them.

Privatization is a central tenet of the economic policies of more and more countries around the globe, particularly since 1989 when Eastern Europe and the former Soviet Union, or should I say, Central Europe and the former Soviet Union, began to transform their centrally planned economies to ones that are market oriented.

However, there appears to be more concern with the number of privatizations as a measure of success—more than 8,500 in over 80 countries since 1980, according to the World Bank—than with the quality and effects of the conversions. Too much is at stake to make this merely a numbers game.

My vantage point from the Banking Committee after the ill-fated passage of FIRREA, which I think was one of the most irresponsible acts of the Bush administration and the Congress, members of my Banking Committee engaged in a numbers game with the RTC.

How many institutions have you closed today? Success was equated with the number of institutions closed, rather than the quality of the actions that were being taken, and I think that had horrendous consequences.

In any event, in my view, the way in which privatization takes place is at least equally as important as the fact that it occurs. Privatization can be a vehicle for either distributing the wealth of a society more equitably or for unfairly concentrating that existing and potential wealth.

The U.S. policy, it seems to me, should recognize such differences and strive for the most equitable distribution of existing and potential societal wealth as is feasible. I am concerned that the U.S. policy, as currently conceived and implemented, does not do that and may concentrate its efforts on the objective of privatization itself, with little, if any, attention to who benefits and who loses in the process.

In my judgment, we have seen too much of the so-called nomenklatura or patron privatization which excludes adequate opportunity for a broader-based process that would enhance the socioeconomic conditions of the greater body politic—what I would call: Empowerment privatization.

I would hope that the concept of empowerment privatization could become a motivating principle, a guiding principle of U.S. policy.

Our policy must bring certain standards to bear, and those standards must reflect the particulars of a country's experience. Privatization comes in many forms and uses and array of methods: Bids, shares, auctions, coupons, et cetera.

I don't know that any one method is inherently preferable. Moreover, the conditions country by country are vastly different. As Poland's former Finance Minister Balcerowicz recently observed, how privatization functions in a country depends on variables such as micro and macroeconomic conditions, department, human capital, and their interactions with political conditions. It seems reasonable then to have multiple criteria by which to measure success depending on the situation of the country.

However, we must not make the mistake of using criteria that only look through the prism of economic data. At our last hearing, one witness argued that Russian privatization has been a huge success because it has been a large transfer, and there are very many owners now in Russia.

In contrast, another witness pointed out that, while Russia's experience has been quantitatively impressive, the economic figures mask the less positive qualitative features of privatization. He noted that, "The promise of fair property distribution among the population was not being realized, and the inadequacies of the privatization program contributed importantly to the worsening of Russia's economy and to the political conflict."

This week the *Financial Times* reported a deep crisis in Russia as output has plunged 25 percent. According to the reported poll, a majority agreed that, "Privatization is legalized theft," and two-thirds of respondents believed that privatization was, "Undertaken for the benefit of nomenklatura and criminals."

Similarly, the *New York Times* has reported that privatization in Mexico has increased competition among the handful of families vying to be Mexico's wealthiest clan. According to a quote in the report, "The booty of privatization has made multimillionaires of 13 families, while the rest of the population—some 80 million Mexicans—has been subjected to the same gradual impoverishment as though they had suffered through a war."

While privatization income helped Mexico's government service its debt, it also caused 400,000 Mexicans to lose their jobs.

If you are not aware of it, I would point out to you that my committee, over a year ago, had hearings in connection with NAFTA on the human rights conditions in Chiapas and we brought up a good number of individuals in Chiapas, including the executive director of the Chiapas Human Rights Commission to talk about what might be happening in Chiapas if those conditions weren't tended to and NAFTA were passed, unrelated to the problem of the working people of Mexico and Chiapas in particular.

The United States and other western governments have offered enthusiastic support for privatization efforts. But general observations of this nature must be coupled with a note of caution. Such caution is particularly important, given that what may be increasing skepticism about our own motives.

In Russia, for instance, privatization policies have become linked in the minds of many with the United States, because of U.S. officials highly visible and public support for economic reforms. A number of western advisers to the Russian government as reported by one of my last hearing's witnesses, are viewed by Russian citizens as representing United States and other western business and commercial interests. In fact, in February of this year, the Wall Street Journal recorded that nearly 50 to 90 percent of the money in any given USAid contract directed to assist economic transformation in Russia comes back to the United States in the form of consultants' fees.

Given the perceived link between reform and western business interests, it is plausible to expect that the United States could share the blame for economic failures and dashed expectations that would result from a privatization effort not sufficiently driven by concerns for equity.

Similarly, press reports this week announced enormous public disillusionment in Hungary with economic reform—and a resulting nostalgia for communism that led to the former Communists, now the Socialist Party, winning 33 percent of the first round in parliamentary elections.

A similar resurgence of Communist support has occurred in Poland and Lithuania. That is certainly not what the U.S. policy on privatization has been trying to achieve.

So I think it is time, I think it is appropriate, for us to ask some probing questions about U.S. policy on privatization and how we implement it. In particular, we must assess whether we are giving adequate attention to analyzing the actual results of privatization efforts and determining who in these societies is benefiting.

We must also determine who in the U.S. benefits from tax dollars going for privatization overseas, and whether such commercial concerns have too great an influence in the formation of our policy or nonpolicy.

Our criteria for success and for failure must be made more explicit, and it is time to make any mid-course corrections in our policy efforts that may be warranted.

We are very pleased this morning to welcome administration witnesses who are knowledgeable about, and intimately involved with, privatization efforts worldwide.

We will begin with Dr. Carol Lancaster, Deputy Administrator for the Agency for International Development, and then we will

turn to the Under Secretary of the Treasury for International Affairs, Dr. Lawrence Summers. We also welcome two Ambassadors from the Department of State, Ralph Johnson, Coordinator for East European Assistance and Thomas Simons, Coordinator of U.S. Assistance to the New Independent States.

We indeed look forward to your presentations. Do any other members of the panel have any statements they wish to make?

Mr. TORKILDSEN. Mr. Chairman, in the interest of time I will just ask unanimous consent to submit a statement.

[Mr. Torkildsen's statement may be found in the appendix.]

Chairman LAFALCE. Without objection, so ordered.

Mr. SARPALIUS. Mr. Chairman, I would like to do the same.

Chairman LAFALCE. So ordered.

[Mr. Sarpalius' statement may be found in the appendix.]

[Chairman. LaFalce's statement may be found in the appendix.]

[Mr. Portman's statement may be found in the appendix.]

[Mr. Dickey's statement may be found in the appendix.]

[Mr. Ramstad's statement may be found in the appendix.]

Chairman LAFALCE. Dr. Lancaster, we will begin with you. We will put the entirety of all of the prepared statements of all of the witnesses in the record as if they were read, and you may feel free to read it or summarize your statements.

TESTIMONY OF CAROL LANCASTER, DEPUTY ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

Ms. LANCASTER. Thank you, Mr. Chairman. I will do just that. Thank you also for inviting me to appear here today. I think you are raising some important and interesting questions on privatization, and I hope I can address some of them in my brief remarks and then in any questions you care to ask.

It is true, privatization is and has been and remains a critical element in creating free markets in our view, and free markets we believe are very important to sustain growth in all parts of the world, including the Eastern Europe and the Soviet Union, or the ex-Soviet Union and Africa, Latin America, and Asia as well.

It is also, as you mentioned, important for building constituencies for economic stability and growth supporting policies. It is also important in terms of fiscal restraint. Governments that have long found their treasuries bled by state-owned enterprises that were inefficient and needed subsidies, often seek privatization as a means of dealing with that kind of a problem, and also, a means of releasing resources, public resources that can be used for purposes for which government is best suited.

It is also an important means of promoting the efficient use of resources throughout a country, and it is a means of reducing rent-seeking corruption in state-owned enterprises that perhaps are not subject to the discipline of a market, or transparency or accountability.

It is true, privatization is a worldwide phenomenon and it has happened of course in the United States and in Britain and in many other countries. The USA is involved in promoting privatization in Africa, Latin America, and Asia, as well as Eastern Europe and the NIS.

Our estimates are that in 1994, we provided roughly \$300 million for privatization efforts in the NIS and Eastern Europe, and roughly \$50 million to support those efforts in other parts of the world.

What did we do? Well, we provide policy advice to governments on general economic policies, including stabilization and adjustment policies and privatization policies. We provide technical assistance to governments on preparing themselves to privatize, on preparing firms for privatization, and we also provide technical assistance for firms, once they are privatized, to be able to be managed and run in an efficient fashion.

It is certainly true that much of the technical assistance monies we spend finance American advisers to governments and to private firms. We do have a great deal of expertise here in the management of the private entities, and I think that that expertise is often very welcomed abroad.

We also provide advice to governments in shaping regulatory frameworks, changing legal codes, and creating commercial codes that will allow a private sector to function where it has not functioned before.

We provide credits and credit guarantees, often through enterprise funds that you are very familiar with, I am sure, in Eastern Europe and the NIS. We are also about to establish an enterprise fund for southern Africa which could undertake similar activities in that region, which will also be a region of I think some considerable privatization efforts in the not so distant future.

We try to help governments build the institutional capacity to deal with privatization on their own. It can be a very complex and challenging process, and so training is an important element in some of what we do.

We provide help in publicizing privatization efforts so that the public and potential investors are aware of opportunities, and we provide help in the creation and management of social safety nets, including employment counseling, severance pay, retraining, and public works activities.

I would just like to spend a moment on the lessons learned from our point of view. I am sure there are a lot more lessons to be learned as time goes on, but we certainly see the following ones as important. Small business is important in the entire area of privatization. Small businesses tend to be easier to privatize. They are job creators, but it is often important also to privatize larger businesses to provide the smaller businesses with the economic space to operate efficiently.

The importance of the Government commitment to privatization is key. Without that commitment, it is very hard to proceed with an effective privatization program. We have seen in a number of countries of the world the importance of transparency and fairness in the privatization efforts. Where that doesn't take place, the efforts are often regarded, as you so rightly mentioned, as not legitimate, as unfair, as benefiting a few.

The importance of an enabling environment to support the long-term success of privatization is another significant lesson learned. The regulatory framework, the legal framework, the economic framework that will allow privatized businesses to function effec-

tively, a competitive environment that will encourage them and indeed discipline them to function effectively are all important.

The importance of having clear objectives in privatization is also key. One of the problems of state-owned enterprises that everybody has recognized for a long time is that they were often loaded with multiple objectives and couldn't accomplish any of them.

We have to be careful, I think, based on our past experiences, that as we privatize, we are clear about our objectives and don't try to do too many things at once and therefore potentially inhibit us from doing any one of them well.

We need to be clear about the strategies that we are pursuing in privatization, whether we go first, whether we go for smaller enterprises first, whether we go for larger enterprises first, what combination we approach the privatization process with.

The process of privatization is also important. How we go about selling off or changing management in privatized entities, and the importance of having the management capacity in government and in the private sector to manage these entities.

As you mentioned, I think it is also very true that we must fit the process of privatization to the specific conditions economic and political in the countries in which we operate, including the size of the firms we are looking at, the strength of the capital markets in particular countries, and the strength of the labor movement. There is not a cookie-cutter approach to privatization.

Finally, in terms of creating social safety nets to ease the costs of transition, our evaluations have shown that where these are well planned and also have clear objectives and have strong implementing agencies and adequate resources, they can be very effective in easing the transition that privatization can create.

They are not always well-managed and well-planned, and in those cases they tend not to be very effective. This is a rather obvious point, but it is one that is worth making and remaking, in our view.

I would like to mention one more thing related to your opening statement, Mr. Chairman. That there is a tendency to look at the numbers of firms privatized and not look at other things that may be much more important in terms of the impact and effectiveness of privatization, I think is a very legitimate point.

I must confess in looking at past USAID documents I was a little surprised to find that at one point in the distant past, not during this administration, we had a requirement or attempted to have a requirement that each of our missions in the field support two privatizations a year. It sort of reminded me of the policeman who tickets parked cars. I don't know whether that was accomplished, but that is not our policy today. I think it is important to look at other aspects of privatization, and I must say that I think we are doing that, and the World Bank is doing that.

You have probably seen this very nice little report that they have done on the lessons of privatization in which they do talk about numbers of firms privatized, but they also talk about the impact on domestic welfare, productivity, labor—the status of labor and so on.

Chairman LAFALCE. I found the multilateral development institutions almost unconcerned about equitable principles in my conversations with them.

Ms. LANCASTER. It may be. That is my colleague's expertise here. But I think that certainly we are also concerned about these things.

I would say that we probably need to do a better job looking at them, but on the other hand, I think the privatization process is also in many places in a relatively early stage, and I think we will have to look at these things as time goes on and see how the privatization of former public entities has worked out.

Chairman LAFALCE. In some places it is in early stages, in some places it is not. In Mexico haven't they completed about two-thirds of the privatization anticipated?

Ms. LANCASTER. It may be that they completed two-thirds, and I am not going to pretend to be an expert on Mexico. But I think that one has to have a little time in to look at how the process works in order to evaluate its impact on labor.

Chairman LAFALCE. If we wait until after it happens, it is going to be too late. We have to anticipate, we have to anticipate. We have to do both. But if we just look after the fact and don't anticipate, it is gone.

Ms. LANCASTER. I think my own view is that it will be helpful to anticipate; it will also be helpful to have some real experience with what has happened up until now.

But in any case, I just wanted to stop and say thanks for letting me participate today, and I look forward to a lively discussion.

Chairman LAFALCE. Thank you.

[Ms. Lancaster's statement may be found in the appendix.]

Chairman LAFALCE. Dr. Summers.

TESTIMONY OF LAWRENCE H. SUMMERS, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SUMMERS. Mr. Chairman, I applaud your initiative in holding this hearing which I think addresses some very real concerns about the privatization process. We believe that privatization is a special pillar in the transformation of economies in Eastern Europe and the Soviet Union and indeed around the world.

We see it as a critical effort to create pluralistic societies in which democracy and free markets can flourish. Many once believed that governments should manage a wide array of economic activities. Today the tide has shifted, the state is retreating from the productive sectors of the economy and the private sector is rushing in.

Indeed, of the many economic ideas that have come to the fore in recent years, industrial policy, rational expectations, I believe that privatization will have the most enduring importance for growth and prosperity.

Chairman LAFALCE. We are at a unique moment in the history of the world.

Mr. SUMMERS. Yes.

Chairman LAFALCE. If we do this right, it could be wonderful. If we do it wrong, we are going to lose this unique opportunity in the history of the world.

Mr. SUMMERS. No question about how important a juncture it is and how important it is to do things right. My testimony has a rather detailed progress report on privatization in the 15 republics of the former Soviet Union and in Central and Eastern Europe that is appended as a table at the back, and I will not try to review that experience.

Let me just highlight seven lessons of the experience and then confront the issue on which you have been focusing, Mr. Chairman.

First, privatization works best when it commands public support and starts from the bottom up. It is at the local level that the dynamism for entrepreneurial activity occurs. Quick privatization of small businesses is one avenue that has generated public support. Voucher distribution programs also give citizens an immediate stake in the free market economy.

Second, privatization and stabilization are mutually reinforcing. Governments cannot manage budgets and monetary policies under extreme pressures to subsidize inefficient enterprises. Where privatization has progressed farthest, so has stabilization.

Third, privatization is essential for renetting the social safety net. It is an anti-inflation policy. It also serves the state's financial commitments to enterprises, freeing budgetary resources for social needs.

Let me give you an example. Mexico had a State-owned airline which they were subsidizing to the tune of \$.5 billion a year, even though less than 3 percent of the Mexican population had ever flown on any airplane.

When they privatized that enterprise, they were able to stop that subsidy and they were able to reprogram that money into sanitation projects in urban areas that provided clean water for the poor. That is an example of what is going on everywhere. Whatever happens to the privatized enterprise, resources in the form of subsidies are freed up and that money is reprogrammed to meet vital public functions.

My fourth lesson: Privatization is but one of many structural reforms which are necessary. I am reminded of an American businessman in the Russian region who told me that the signature on a contract only signified that his client had attended the meeting. To attract foreign capital, contractual law and private property must be respected and tax systems must be fair and transparent.

The fifth lesson, and one that is embodied in the design of our programs, is the clear need for post-privatization assistance. Privatization changes the basis of ownership, but for firms to compete, they have to vastly overhaul and restructure their operations.

In market economies, firms have access to business infrastructure to address these deficiencies. This is lacking in transition economies. An effective financial system, in particular, can provide the lubricant needed to expand the operations of promising firms.

Lesson six is the privatization should happen as rapidly as possible. In thinking about privatization, I like to use the example of selling a house. It surely makes sense before you sell your house to ensure that the title is secure. It may make sense to weed the

yard or patch a hole in the driveway. But it is almost certainly a mistake to add a swimming pool in anticipation of a potential buyer who might want one, or to start restructuring the bedrooms in the hope of making the house more attractive. It is better to put the house on the market and let the buyer adapt it as he or she chooses. So, too in the area of privatization.

The idea that governments should restructure enterprises before they are privatized misses the fundamental advantage of privatization, that those with a direct financial stake in an enterprise, as they have after privatization, will have the incentive to do that restructuring as efficiently as possible.

Yes, the title should be secure. Yes, essential maintenance should be performed, but the idea of major restructuring prior to privatization has almost everywhere been found to be disastrous in its consequences.

Seventh, while there is no shortage of excuses for slowing privatization, there is a strong case for looking to its long-run benefits. I do not accept the proposition that privatization costs jobs. Privatized enterprises often downsize, but that is necessary if they are to compete. Privatization, by getting out of the way, enables governments to do other things to create jobs and permits further expansion in the private sector, which creates jobs. Those who would wait for ideal conditions fail to grasp the importance of moving promptly ahead with what is doable.

Mr. Chairman, I share your concern about nomenklatura privatization. This can severely undermine public support and can in some cases fail to realize punitive benefits of privatization. But we must also recognize that the benefits and costs of privatization will never be distributed to everyone's satisfaction, that privatization initiates a process in a market economy that ultimately brings about a rising prosperity.

If one pursues an approach of selling off assets, particularly in the former Communist economies, there is a very difficult choice to be faced. One is to confiscate the wealth of previous Communists, confiscate wealth. The other is to recognize that some of those who have accumulated the most wealth are going to be able to buy assets. That is a very difficult dilemma.

It is because of that very difficult dilemma that many have advocated as an alternative approach to privatization plans such as those pursued in Czechoslovakia that rely on a voucher system to create broad-based public ownership. I think the record so far in Czechoslovakia, the Czech Republic now, suggests that such approaches have been successful in creating widespread ownership.

To be sure, there is a problem where the transfer of ownership does not mean an effective transfer of control. But it is no answer to that problem to allow the current nomenklatura to simply operate those plants without any security, any whatsoever, from private ownership.

What I am saying in a word, Mr. Chairman, is that in the situations where we confront privatization issues most graphically, whether it is in FSU or it is in Latin America, or it is in Africa, we are confronting economies with very serious difficulties; we are confronting governments that have real difficulties in performing even the most basic function of enforcing the law.

So as we approach the question of privatization, we should not approach it from the perspective of whether the privatized enterprise will function in the way that an American corporation embedded in the American capital market does, but we need to approach the question from the perspective of whether it will function better with a private owner than it did in the hands of a weak and decaying state.

In that perspective, I think it is difficult to make the case that there have been excessively rapid privatization in the former Soviet Union or in Latin America, or in Central Europe. I think the greater imperative is to push the process of privatization ahead and to work with enterprises that have been privatized so that they can produce as effectively as possible.

The remainder of my testimony, which I will not try to read now, talks about the special privatization restructuring program and the fund for large enterprises in Russia and the EBRD small and medium enterprise fund which are U.S. initiatives in support of privatization with which the Treasury Department has been assessing.

Chairman LAFALCE. Thank you, Dr. Summers.

[Mr. Summers' statement may be found in the appendix.]

Chairman LAFALCE. Our next witness will be Mr. Ralph Johnson.

TESTIMONY OF AMBASSADOR RALPH R. JOHNSON, COORDINATOR FOR EAST EUROPEAN ASSISTANCE, U.S. DEPARTMENT OF STATE

Mr. JOHNSON. Thank you, Mr. Chairman. With your permission, I will summarize—

Chairman LAFALCE. Mr. Johnson is the Coordinator for East European Assistance with the Department of State.

Mr. JOHNSON. Thank you, sir. With your permission, Mr. Chairman and members of the committee, I will summarize my testimony.

I am grateful for the opportunity to appear before you to discuss our assistance programs in Central and Eastern Europe and the subject of privatization.

I would like to start by expressing my praise for the work of the Central European Small Business Enterprise Development Commission established, Mr. Chairman, at your initiative.

The programs that have been created by the Commission are enjoying strong host government support, and we think they are making an important contribution to the development of a viable small business sector in the countries in which they are operating.

Mr. Chairman, in the context of our assistance programs to Central and Eastern Europe, we use a rather narrow definition of privatization policy. We try to promote as rapid a transfer as possible of all nonstrategic assets from public to private ownership.

I would like to outline what I see as the four major components of that policy. My testimony contains some more detailed information about how we assess the results of each of these approaches, but I would rather summarize for you, in the interests of stimulating discussion, the approaches themselves.

First of all, we try to ensure a rapid and transparent system for negotiating actual sales by helping create the needed legal structure for transfers. We seek to group sales into mass privatization schemes, training host country staff in the skills needed for the actual sales.

We do provide technical advisers in accounting, investment banking, and corporate law in order to help operate these mass privatization programs.

Second, we work to help governments facilitate the liquidation of nonproductive firms through bankruptcy, State company breakups and asset sales. It is fair to point out that few countries have in fact, chosen to use the bankruptcy route as a principal avenue for privatization.

Third, we are helping to develop local capital markets, voucher fund and share privatization programs and employee stock ownership plans to augment local investment in privatized firms and assets.

Fourth, we put special emphasis on bank privatization and on the creation of local investment banking capabilities to ensure success in the post-privatization period, since the process of mergers and liquidations will continue well beyond the main privatization program and must be managed through the local financial sector.

As Dr. Summers has said and as you have observed as well, simply privatizing these firms is no guarantee of their success. It is clear that there needs to be an environment in which they will be able to have access to capital and an environment in which they are able to operate in a free market.

I would like to adhere that we talk about privatization as a way of creating a private sector in the countries of Central and Eastern Europe. But in fact, Mr. Chairman, there is another dimension to this process, which is the creation of conditions under which private activity can spontaneously arise.

An important part of our effort in our assistance programs is dedicated to helping create that environment through legal changes, through changes in reform of financial systems, restructuring banking systems. It is important that we bear in mind that creation of jobs and the development of a private sector is not only going to be accomplished and maybe not even primarily going to be accomplished by the privatization of the existing state firms, that in many countries what is absolutely crucial to the growth of the private sector has been the development of new companies, companies that were not formerly in the private sector, but are the result of new and fresh initiatives.

With your permission, Mr. Chairman, I would end my prepared remarks there. There are further details in my testimony, in the interest of opening the door to a discussion.

Chairman LAFALCE. Thank you, Mr. Johnson.

[Mr. Johnson's statement may be found in the appendix.]

Chairman LAFALCE. Our last witness, Ambassador Thomas Simons, Coordinator of U.S. Assistance to the New Independent States.

TESTIMONY OF AMBASSADOR THOMAS W. SIMONS, JR., COORDINATOR OF U.S. ASSISTANCE TO THE NEW INDEPENDENT STATES, U.S. DEPARTMENT OF STATE

Mr. SIMONS. Mr. Chairman, I too am grateful for the opportunity to appear before you and applaud your initiative in calling these hearings and in posing some of these important questions for us.

I will say a few words about my prepared testimony, and also perhaps make just a few points that the other witnesses have not made, although many of my points have been made, not unnaturally, by the other witnesses.

My testimony focuses on Russia, on our programs in Russia and on progress there. Russia has been the leading country among the 12 New Independent States for which I am responsible, and the progress of the program and the problems of the program are being looked to by the other countries who are now embarking on privatization programs of their own. So, the focus of my testimony is on Russia.

Let me just make three points, picking up some of the things that you said and some of the things that my colleagues here have said. We, of course, could not agree more that empowerment is the key objective of the privatization program, of the economic as well as of the political transformation.

Taking the economy out of the hands of the state and of the state nomenklatura which controlled it when it was in its state-owned form is of course a key objective. At the same time, we must also remember that we do not, as the United States, either the U.S. Government or American advisers, determine the course of these processes.

We must be guided by reformers in the countries themselves. It is not for us to impose any single model. Our task is to work with them as they develop their own initiatives, the forms of programs that are appropriate to their countries and possible in their countries.

In Russia, it was Russian reformers in the Russian government who chose mass privatization, the rapid transfer of property out of State hands into vouchers and then into shares. We supported that process and it was our advice and assistance which helped to make it transparent, regulated; in other words, which helped to make it not an under-the-handkerchief, hole-in-corner process, but a process of wide transparency, understandable to people and participated in on a wide basis, and that will continue to be our approach.

The second point I would make, Mr. Chairman, is that—and some of my other colleagues have made it—is that our approach to privatization, to advice and encouragement of privatization, has three elements rather than simply one.

The first element is the formal transfer of property from the state to individuals, but the other two elements are equally critical. Formal transfer of property is only a first step toward the development of an efficient and functioning market economy with efficient competitive firms, which can offer solid, stable employment to their employees.

The other two elements are providing capital for privatizing firms. That is the purpose of the series of enterprise funds which are being set up across the area.

Five official funds, three private funds with an American contribution of in the neighborhood of \$.5 billion for Russia, upwards of \$300 million for the other eleven republics—well, for the other eight republics where we now contemplate setting them up, funds which will provide capital in the form of credit and equity shares for privatized firms to allow them to restructure and to make themselves competitive and efficient in a market environment. That was the second element.

The third element, Mr. Chairman, is precisely advice and encouragement in the creation of the total legal, regulatory, and institutional environment which firms require to survive and prosper. We have talked about some elements here, the banking sector, the development of capital markets, fiscal sector reform, the legitimate enforcement mechanisms of any democratic state, rule of law, contract law and the development of independent courts to enforce contracts; the whole environment which did not exist under socialism, which does not now exist with the decay of institutions and which we are helping these countries to try to create.

So that is a three-part approach, Mr. Chairman, to privatization. To the extent that it is successful, we also feel that your concerns will be addressed.

A final point with regard to the popularity of the program. It is true that these are countries now blinking in the sun of freedom and independence for the first time in many years. They do have a tendency to blame outsiders for their troubles.

The United States can be one of the outsiders that is blamed for the pain of reform and for the pain of transition. At the same time, Mr. Chairman, our data, the data on the popularity of the privatization program and process in Russia, are somewhat different from yours.

I believe your statement said that two-thirds of the population are against it. The data that we are seeing show that it is fluctuating between one-third and two-thirds, but most polls are showing approval ratings for the privatization program in the neighborhood of 60 percent, and they are in the 60's at this point.

Ninety-seven percent of the Russian population got vouchers; over 50 percent have shares now in privatized enterprises. The program is politically popular; it was not affected by the changes in government which took place in January following the December election, and our feeling is that if the program remains popular, politically popular as it appears to be, our support will give us a share of the credit, just as failure will give us a share of the blame.

Thank you.

Chairman LAFALCE. Thank you very much, Ambassador Simons. [Mr. Simons' statement may be found in the appendix.]

Chairman LAFALCE. I am no expert on any of these issues at all; it is just that I am so deeply concerned. I had one witness at my last hearing, a professor who spent years in Russia studying this issue of privatization, and I know that he has written a book. He is deeply, deeply concerned and I have seen polls that can tell you almost anything you want to hear too, and I have seen polls that have been conducted by the U.S. Government and Russia, for which results have been proven disastrously wrong. So, I don't know.

Of course, I don't have data; I can just refer to other data. I try to read dozens and dozens of different magazines, books on every subject in the world, but one of the ones I try to read is the New Republic, and in the April edition, one article indicated that in Russia the Mafia's, "Godfathers divided zones of influence and went after the 6,000 enterprises coming up for auction in Moscow. The rules for privatization were fluid. Corrupt officials would easily come by and most Russians had no money. The press recorded that the Mafia had privatized between 50 and 80 percent of all shops, store houses, depots, hotels and services in Moscow."

Are you familiar with that article in the New Republic?

Mr. SIMONS. I am familiar with the report.

Chairman LAFALCE. The press report?

Mr. SIMONS. We are certainly familiar with the problem. Crime and corruption—

Chairman LAFALCE. What is your assessment? Do you think it is an accurate assessment that the Mafia had privatized between 50 and 80 percent of all shops, store houses, depots, hotels and—

Mr. SIMONS. We do not have access to independent data. It seems to us exaggerated in terms of the extent, but accurate in its description of the problem. The question is, what kind of a solution.

Chairman LAFALCE. To be sure.

Mr. SIMONS. We do not think the solution is not to privatize.

Chairman LAFALCE. No, nor am I suggesting that. I think that privatization is important.

But my query is whether or not policy goals of the U.S. Government have in mind, in their articulation, important considerations other than the mere fact of privatization.

I am not adequately convinced of that. I mean people might give lip service to that. They might toss off seven to a dozen separate goals. But I am not convinced that in the process of privatization, at least one of those goals, the more equitable distribution of existing and potential societal wealth is really important.

Mr. SIMONS. Mr. Chairman, there may be a philosophical difference. Equity is important to the U.S. Government, to the extent that we influence the process.

I previously made the point that we do not run these processes at the distance of 6,000 miles. We help and give advice to those who do.

At the same time, we also believe that growth is important to equity. In other words, dividing a shrinking pie, you will likely get more crime and corruption.

Chairman LAFALCE. I understand all that. I understand that. But I also understand too that you have to have increases in economic growth in greater and greater disparity between the haves and the have-nots.

Trade liberalization is a wonderful concept, but that can and all too often has lead to greater disparity between the haves and the have-nots. It is going to keep happening that way unless somebody says, we have got to do something about it and means it.

When we hire outside people, when we hire the big accounting firms, when we hire the big investment firms, they really don't care that much about equitable considerations. The U.S. Government

doesn't, there ain't nobody going to. I am not convinced the U.S. Government feels this enough.

Mr. SUMMERS. Congressman, I think there are two separate issues that we need to—and we need to consider them separately.

One is the question of Mafia involvement and organized crime, and the second question is the question of whether this is helping the rich or helping the poor.

Let me speak if I might to each of those. I think the broad point that I would emphasize is that you have to compare alternatives here, and there is no good alternative.

And we have taken the position that by and large, when you have a state-controlled, state-operated steel company that is run by the traditional Communist nomenklatura who have been running it all along, that almost anything you do that brings some outside owner in and gives them an incentive to increase efficiency and which cuts off the hemorrhaging subsidies from the government to that steel company makes things better, because it doesn't become more prone to the Mafia when you separate it from the state; it was prone to the Mafia before.

The influence of that nomenklatura is reduced somewhat, and when you think about equity, you can't just think about it from the point of view of, yes, somebody bought the thing and maybe somebody got rich; you also have to think about the equity consequences of reducing the flow of subsidies, which often are going to workers who are among the most highly paid in the country.

Chairman LAFALCE. I accept the validity of everything you say.

It is sort of like some tank commander saying, oh, according to the book, we can't get from here—or more than from here to the door, and Patton is saying, yeah, but we have got to do 10 times better than that, and Patton does it, and it is attitude and approach.

I don't sense anybody in our Government with an attitude or an approach who says, my God, we have got to do better than just say that, well, after the nomenklatura, turn it over from the state to the nomenklatura, then because it is privatized, we will then be able to do better and we can declare success.

Happiness is based in large part upon one's expectations, and I want us to have greater expectations in the short-term, have it happen, but be unhappy about the way it happened at least, but at least have those high expectations and have equitable considerations and principles as part and parcel of those expectations so you go back home and don't say, we did it, we give ourselves an A plus, go home and say we did it, but it sure as hell wasn't done the way it should have been done; give yourself a C.

I mean what is our attitude?

Mr. SUMMERS. Congressman, let me make three points. First, nobody in this Government is complacent about anything that is happening in Central Europe or the former Soviet Union. Nobody thinks that this is a great triumph in which everything is going wonderfully.

We are all trying to do the best we can, but I don't think anybody is patting themselves on the back and saying that everything is perfect or everything is going as well as it could go over there.

Chairman LAFALCE. When did we have a meeting within the councils of the U.S. Government to discuss primarily more equitable distribution of the potential wealth of society during the privatization process?

I know under AID's leadership and with the Department of the Treasury that we had a symposium in October of 1993. But I have talked with the president of one multilateral development institution. We talked for about 15 or 20 minutes. He said, I have never heard such a lengthy conversation on this concept at all in my entire institution. He was just being very open, very, very candid, very frank with me. Of course that was disheartening to me.

Mr. JOHNSON. Mr. Chairman, maybe I could give you an example of a program that does address the small- and medium-size business sector, which I think goes some distance toward getting at your concern.

Each of our enterprise funds, which we have created, operates under a grant agreement from the U.S. Government. These are private sector boards. But throughout Central and Eastern Europe where we have set these funds up, we have made it a special issue for them to focus on efforts to reach out to make credit and equity available to small- and medium-sized business people.

In the Polish case, this is our largest fund, a fund of about \$240 million. They have done that, putting out about \$20 million, I think 2,000 to 3,000 loans now, generating employment as a result, but also, training bankers in Poland in the way in which they can now make credit available or, in some cases, equity available to small businesses.

Other enterprise funds of ours in the region are pioneering the same thing. In fact, we are now talking in Poland, not just about small and medium-sized enterprises, but actually about microlending.

The reference to the international financial institutions is an important one. In fact, our experience has been that some of the IFT's have had difficulty getting out the loan programs, simply using the existing domestic banking system as a vehicle.

What we now find is that many of these institutions are turning to the enterprise funds as partners. In the case of Poland, \$50 million was put in by the EBRD into a fund which will operate under the auspices of a creation of the enterprise fund.

So I think that we are looking at the small- and medium-sized sector. We are looking at how we can stimulate growth, not simply through privatization, but rather through helping new business people, because most of these are new businesses. The enterprise funds have been little involved, frankly, in privatization.

Chairman LAFALCE. This is what moved me when I got back from Central Europe in 1990 to say, we have to do something, we have to create a Central European economic development commission to foster and promote small business development in these countries, which I thought would be so important.

I was pleased at your praise of that effort. Of course, you know the administration has called for its elimination this year.

Mr. JOHNSON. I understand that the Small Business Administration, which has been funding the enterprise, has not pledged to fund it for the coming year.

Chairman LAFALCE. The Small Business Administration would very much like to. It is OMB.

Mr. JOHNSON. I see. I recognize the nature of that problem. I had it myself.

Chairman LAFALCE. Well, we are going to have to talk about that. I have a lot more questions.

Bill?

Mr. SARPALIUS. Mr. Chairman, I want to share with this committee an experience I went through and would like to have the witnesses' input on it.

I recently went to Russia to cut the ribbon on the first Radio Shack in Moscow. I asked a lot of questions and learned a lot. This was more or less a partnership with a U.S. franchise in Moscow. Their goal was to eventually open up about 300 Radio Shacks all over Russia.

What I found out was that, one, the only way they could open this store up was to literally box up a Radio Shack, put it in two containers and ship it over there. Keep in mind they had 34 employees, of which 30 were Russian citizens, so it was an opportunity there for jobs.

When they opened up their store, Radio Shack was only able to get one container through customs. I found out that they had to pay the Mafia a substantial amount of money in order to open this business. The only way they got one container through customs was to pay off the people in charge of customs.

The director of customs in Russia said there were lines of trucks at the border waiting to come in. The only way to bring anything into the country was to put some money up front.

Russia also has a committee that sets up international standards. For example, many radios that Radio Shack sells are accepted throughout the world, but Russia wants to set their own standard. If the international standard is accepted, it costs money.

The same thing with cellular phones—most of the electrical equipment that Radio Shack dealt with. I met with the owner of the standards facility, and I was amazed at the bureaucracy, the frustration—his own private office had to have people at the door to check anybody that comes in, for fear of Mafia coming in and wanting more money.

With the way the system is set up, we can throw in all the money we want to, but unless we show the Russians how opening up the door through customs can open up more opportunities for small businesses within that country, we will never help stimulate the economy.

I learned a lot from that trip. I was amazed that they were even able to open up the business. I can understand the frustrations of many companies that want to go in there and establish chains of small businesses, but they cannot get them going, and in cooperation and in partnership with those countries.

I would like to have your input on what do you think the answer is.

Mr. SIMONS. Congressman, you have certainly vividly described a very common problem. I went with Secretary of Commerce Ron Brown and 28 CEO's and presidents of major American firms who were interested in doing business there.

I have been three times over the last year, and we have always met with the American Chamber of Commerce. What you are describing is unfortunately very characteristic of the whole atmosphere. It is a very hard place to do business in.

The old structures, the state-owned economy which permitted you to go to one man, or his boss, to get your permits and to get everything you needed to do a little bit of business in the Soviet Union has disintegrated, and nothing has yet taken its place.

The question is, what do you do about it? And we are doing exactly what you suggest. In other words, we are using our modest assistance resources to help them buildup the whole legal, regulatory, and institutional structure which will permit safe, productive, honest business to be done by Americans and by Russians, the banking system, customs system, the serious tax system, courts to enforce these laws and regulations, the functions of a democratic state.

Customs, you spoke of customs. I think that will be one element of the kind of stabilization and regulation that is going to be needed to definitely fulfill the potential of business because it is very clear to us that assistance cannot be a solid basis for economic relations.

Right now our assistance programs are two and three times the amount of American direct private investment in Russia, which is about \$2 billion at this point. That is anomalous.

Private sector trade and investment are going to have to replace assistance. We want to use the assistance program to help form the environment for that happening. That is one element.

But I would like to ask Secretary Summers to talk about the other element, which is macroeconomic stabilization. Because one of the things—one of the reasons you get criminality of this kind is because the dollar is a better currency than the ruble, and you have, just weird foreign exchange systems, which encourage crime and corruption, and that is another way to attack it, which we are.

Mr. SUMMERS. Well, I think the way I like to put the point is to say that quite possibly, the best thing the United States ever did to reduce organized crime was repeal prohibition, and it did that because when you have things that are legal, there is no diversion from black markets to white markets.

When you don't have customs restrictions, there are no customs inspectors to bribe. When market interest rates govern loans, rather than huge negative real interest rates, there is no point in threatening a bank lending officer.

I could keep going with the examples. But the point is that one of the very important features of moving to a market system is that you move, what Carol Lancaster called in her testimony, the rent-seeking activity, the rents that are there that you can extract from pressuring the government in a certain—in a certain direction or to take a certain policy. I think that moving to do that is beneficial in the sense that there is less scope for corruption when you have a more market-oriented system, one.

Two, when the government is out of the way, is not doing those things, it can do the things that only governments can do in terms of enforcing laws. So, I think that has to be a complement to the kind of approach that Ambassador Simons describes.

I think, Mr. Chairman, that you are performing a valuable service by emphasizing the importance of this equity issue. It is something we have tried to be sensitive to, the so-called SPPR, Special Program of Privatization and Restructuring that was announced at the summit last year includes a specific component of—

Chairman LAFALCE. Which summit was that?

Mr. SUMMERS. The G7 Summit in Tokyo, that was a \$3 billion program taken at the United States' initiative, included explicitly a provision for support for dealing with the social consequences of privatized enterprises, maintaining the flow of education and health services.

But I think if you detect some reluctance or some resistance, it is not because of any lack of conviction about the importance of the things you say; it is because of an awareness that those who want to slow the process down, those who are entrenched and don't want to see privatization, cloak their arguments in exactly the same kind of language that we are talking about today.

That tendency seems to us to be one that would be very much subversive to the process of reform that we want to see. So, I think we do have to be very careful about giving aid and comfort to those who would allow current Communist governments to continue to run the enterprises the way they have been run in the past.

Mr. SARPALIUS. Mr. Summers, can you tell me what we are doing with the Russian government to stop the Mafia and the pay-outs on the borders through customs?

Mr. SUMMERS. I can mention one thing that is under discussion, that in the multilateral context. Ambassador Simons has responsibility for the U.S. bilateral program, and so I will let him speak to what the U.S. is doing bilaterally.

But one of the things that came out of the G7 Summit in Tokyo was the agreement to form a so-called implementation group which has a representative from each of the seven countries that is chaired by an American, Michael Gillett.

They are meeting with the Russians this week in fact, to discuss procurement policies and to discuss reform of procurement policies and whether there is a way of centralizing procurement policies through a system that would circumvent the existing corrupt, in some cases, corrupt customs process.

That is a multilateral initiative in which the United States is leading.

I am sure Ambassador Simons could speak to other things that are being done.

Mr. SIMONS. Congressman, we have a variety of programs to help in this area. We work with customs, we work in the tax field for instance. But because we are aware of the magnitude of the problem, we would like to focus and refine what we are doing, perhaps enhance it. I think crime and corruption is an area that no outside country can take responsibility for. All you can do is to try to help in certain areas, and Senior Coordinator James Collins now chairs an interagency working group first to try to get a better fix on the magnitude and character of the problem, and to see what it is that we can do in addition to what we are doing.

But it is important to keep in mind that the United States is not going to solve this problem for Russia or the Ukraine.

Mr. SARPALIUS. But the United States has a very strong arm because we send a substantial amount of money to help Russia establish its economy. If it is difficult for small businesses to develop in that country, we ought to put some restrictions on where our money goes. Russia needs to show some real leadership on the borders, and stronger enforcement in dealing with the Mafia.

If you have been to Russia, it is apparent that the money intended to stimulate the economy is not doing so. I think we ought to be convinced, I ought to be convinced as a Member, before I vote to send money over there.

Mr. SIMONS. First of all, it is important to recognize that we do not give cash to government. That is not the character of the program. We provide advice. We are engaged when it comes to technical assistance in the transfer of know-how and expertise.

The Chairman raised the problem of how that is delivered, the problem of consultants. But the fact that you are providing know-how and expertise through consultants I think means that your taxpayers' money is not going into corruption and crime.

I mean it is a certain hedge against that, precisely, because it does go mainly to America. The program is blocked out in terms of what we believe are the strategic priorities. I would hate to withhold that money because of a crime and corruption problem. I would hate to draw down money from what we have identified as strategic priorities for reform, for the transition to democracy and the market, as a kind of lever to get some action on crime and corruption, where we will not be able to do very much. But we do want to do more.

Mr. SARPALIUS. Mr. Chairman, if you don't mind, I have one more question.

The U.S. recently pledged \$350 million for economic reform in the Ukraine. Two-thirds of the money is free aid and the other third is set up as a loan.

Now, can you tell me what restrictions are placed on the two-thirds that will not be paid back?

Mr. SIMONS. Congressman, I describe it—I am not sure where you get one-third and two-thirds. If I could describe the program a little differently.

Of the \$350 million, \$105 million will be for humanitarian assistance, \$30 million for medicine, and \$75 million for food. Now, of that food, \$15 million is grant and \$60 million is credit. At the other end, it includes \$50 million in OPIC support, support by the Overseas Private Investment Corporation for American trade and investment activities in Ukraine. That is insurance that we expect to get back, I mean, depending on the deals we get.

The centerpiece of the program, \$195 million of the \$350 million, is grant assistance, and of that, \$45 million is to capitalize an enterprise fund for Ukraine, Belarus, and Moldova, which you have heard about this morning, one of a series that we are setting up in the area. And \$150 million is in technical assistance.

Now, once again, this is grant assistance, but it is not to Ukrainians, it is to American experts and consultants on a whole wide variety of projects. So, I am not sure where you got the loan figure.

Chairman LAFALCE. I have been called away for about 10 minutes. I am going to ask Mr. Sarpalius to chair this for about 10 minutes.

If he has to go, I would ask you to wait until I get back, just take a temporary recess, because I have many, many more questions. Would you have some time constraints that you have to leave?

Mr. SUMMERS. 11:30 for me.

Chairman LAFALCE. Really? You couldn't stay until 12?

Mr. SUMMERS. Quarter of 12.

Mr. SARPALIUS. Mr. Chairman, if I could just conclude on the Ukraine program.

We would expect the \$60 million in credits for food to be repaid at some point. The \$45 million for the enterprise fund, we expect that to operate like a business and get back its capital or most of it. So, maybe that is the third in loans that you are talking about.

Mr. SARPALIUS [presiding]. Educate me more about food credits. How does that work?

Mr. SIMONS. I am not perfectly sure myself. These are USDA concessional sales which are on very easy terms. I think it is a 2- to 3-year grace period, and then a 7 year repayment at very low rates.

Mr. SARPALIUS. Will Russia buy agricultural products from this country?

Mr. SIMONS. That is right.

Ms. LANCASTER. Maybe I could just add something on that. We typically will provide a government with the credit that they then use to buy our agricultural products in this country, and I think that is what Ambassador Simons is talking about.

We do this in other parts of the world too.

Mr. SARPALIUS. Another problem I have learned that maybe you can help me with is in Lithuania, which Lithuania, I think you showed some real leadership on the first country to ask for free elections, and got the ball rolling toward democracy over there.

But in that country, they have one of their largest means of helping their economy was in the processing of cotton. Well, the Russians then dumped all of their cotton on the world market. Those factories have now closed, a lot of people unemployed.

Is there anything that can be done to help businesses along that line?

Mr. JOHNSON. Mr. Chairman, I frankly was not aware of this chain of events. We don't have any program in Lithuania which will tackle that particular problem.

This problem of large manufacturers of commodities that dump into the world market is one that in my view is probably only going to be resolved as we bring the countries, in this case Russia, more into the trading system so that they commit to respect the kinds of rules which all the rest of us do.

With regard to the fate of this particular cotton mill, I need to inform myself better, because I don't know the details.

Mr. SARPALIUS. Well, it just so happened that in that particular part, there were several cotton gins that were processing the bulk of the cotton harvested back when it was a Communist country.

Some people got the idea of dumping all this cotton on the market.

Mr. JOHNSON. But the cotton was already inside Lithuania?

Mr. SARPALIUS. No. The cotton was grown—

Mr. SIMONS. Uzbekistan.

Mr. SARPALIUS. Right. But a lot of it is shipped up there, processed into linen, clothing material, and when they dumped it on the market, they put all of those people out of work.

The people who dumped it on the market probably made some money, but in the process, they put a lot of people out of work.

Mr. JOHNSON. It is hard to counter that kind of activity with an assistance program, except insofar as you can provide advice to a country about how they shape their own trade policy so that they develop mechanisms such as we have to cope with situations in which they detect dumping going on.

We have seen in the case of Central and Eastern Europe, farther south now, that these instruments are beginning to be developed in part, frankly because there are claims that some agricultural production from the European Union has from time to time been dumped into central European markets.

So they are having then to develop the trade mechanisms to defend themselves.

Mr. SARPALIUS. Mr. Summers was it your testimony that had the graphs in the back that showed what each one of the countries were doing?

I recall that within Russia, the number of people going into farming or had small farms had increased substantially. You said that as of January 1994, there were 270,000 private farms, 50 percent more than a year earlier.

Are you seeing that trend occur throughout all of these countries? Are they moving more into private farms? If they are, is there any control over what they produce?

Mr. SUMMERS. Well, I think that if you just run your eye down that column across several pages, what you see is that relative to the other republics of the former Soviet Union, Russia is actually moving ahead relatively more rapidly than a number of the others.

I think that is one of the reasons why we are relatively encouraged about reform in Russia, and that is something which I think is not out of the realm of some of the issues associated with it that Congressman LaFalce focused on, because that is really poor farmers get to farm their own land.

So you don't have the kind of antipoor issues that arise; you don't have the loss of job issues that arise in some of the industrial privatizations.

Yes, I would assume that there is more freedom when you own your own plot of land to decide how you are going to farm it, what crops you are going to plant and so forth.

I think the reality is that in many cases what we are thinking of doing—what we are doing here is breaking up very large state-run farms. So, in the short run, there is pretty much a plan for the area, there is a set of machinery that has been adapted for that area.

That machinery is then shared among different people who own plots of land. So, I wouldn't want to exaggerate the amount of change in the cropping strategy that you are going to get in the short run out of privatization.

Nonetheless, experience everywhere in the world, nowhere more dramatically than in a country we haven't talked much about today, China, experience everywhere in the world demonstrates that when you let people keep what they farm, they farm a lot more than when you let somebody else keep what they farm. So, I think the privatization is very encouraging development for Russia.

Mr. SIMONS. Congressman, we are putting a substantial amount of assistance money into the land privatization program. Two other countries are ahead of Russia, Lithuania, which is not—which is in Ambassador Johnson's program and not mine, and Armenia, which is mine, have very substantial land privatization. 270,000 private farms is not much in a country like Russia that has between 20 and 25 million farmers.

So I think you need to keep it in perspective as to how large this movement is. There are 41 million private plots, which is a different category.

The problem that arises—what Secretary Summers said is true, but it is also a problem—if you break up the collective farms, those collective farms, like a factory, provide a wide variety of social services that in our country are typically provided by government or by other agencies, the education, the culture, the health, and so you do need in fact, to work not only on privatizing farms, but on the environment for business, for agricultural business in the rural sector.

We have programs to help make that transition.

Mr. SARPALIUS. It is almost like going back in time and seeing small farms trying to produce enough for their family. If they can produce a little extra, they try to sell it.

Mr. SIMONS. It can be a lot better than that. Last month I visited 1 of the 300 private farmers in Belarus, which is a country of 10 million between Russia and Poland. There are only 300 in the country.

This man was a former collective farm director. Both he and his wife were from Kulak families, the prosperous farmers who Stalin destroyed. Both of their families had been deported to central Asia, had come back to Belarus, and he had gotten himself 50 hectares from the collective farm and he was raising potatoes and raising pigs. His wife was raising the pigs, and he was organizing a consortium of potato farmers, some of them still on collectives around the country, to do storage so that they could hold their crop and not depend on the state pricing system.

He was having a wonderful time, and he was doing actually very well. So, I wouldn't be too pessimistic.

On the other hand, when I asked them, you live in a village where everyone else is on the collective, are you an example to them because you are doing well? He said, are you kidding? I work too hard for them. So, there is that aspect as well.

Mr. SARPALIUS. Well, we have a vote going on, and I guess we will recess for 15 minutes.

(Recess.)

Chairman LAFALCE. Is a representative from the Treasury Department here? Mr. Summers had to leave. Is Mr. Simons still here?

Mr. JOHNSON. I am confident he will be back, Mr. Chairman. I have a feeling he stepped out for a cigarette.

Chairman LAFALCE. I don't have much control over the legislative schedule. I understand shortly after I left, the bells rang for a vote.

Well, let me begin. What mechanisms do we have within the U.S. Government for discussing the issue of privatization and formulating U.S. policy?

Mr. JOHNSON. Well, we have a variety, sir, in the sense that as we look at the time the assistance programs, now I will speak about Central and Eastern Europe. We have a regularly operating interagency process which I coordinate, but which includes agencies from throughout the executive branch that discusses all aspects of our policy with regard to the region.

Indeed this week we are in the process, in fact, over the course of the next several weeks, of reviewing our strategies with respect to each of the countries of the region to take a look at the whole range of activities.

So privatization fits there, but also merits——

Chairman LAFALCE. If I could just interrupt you, because what I had in mind is do we have any interagency mechanism that meets on some regular basis in an attempt to coordinate the efforts of AID, Treasury, State Department, the activities of the executive directors of the IFI's, et cetera?

Mr. JOHNSON. Yes, we do, the process that each of us as coordinators lead is an attempt to accomplish that, that is, to bring together all of the interagency community, all of the people who are involved either directly or as contractors.

Chairman LAFALCE. Is there either an official or unofficial chairperson of this group? Is there something that is called an interagency group?

Mr. JOHNSON. Yes. Each of us as coordinators is identified, in fact, in legislation, in my case, in the SEED legislation, as the person who is responsible for coordinating the development of policy with respect to our assistance toward this region. We work very closely.

AID is our closest partner in this.

Chairman LAFALCE. Does AID work under your—is there some chief coordinator?

Mr. JOHNSON. Yes.

Chairman LAFALCE. Does Treasury work under State? Does Treasury take the lead in coordinating this or does AID?

I noticed it was AID that sponsored this October forum, was it not, or maybe not.

Mr. JOHNSON. The policy coordination——

Chairman LAFALCE. I just saw Brian Atwood's picture here.

Ms. LANCASTER. It is sponsored by the American Foreign Service Association.

Chairman LAFALCE. So it is private?

Ms. LANCASTER. Well, they are officers and retirees from State and AID.

Chairman LAFALCE. But they are private?

Ms. LANCASTER. I suppose they are private now. They have been privatized.

Mr. JOHNSON. The coordination on a topic like this would be—
Chairman LAFALCE. It was cosponsored by USAID?

Ms. LANCASTER. I think they put a little bit of money into it.

Mr. JOHNSON. But coordination on policy questions is, that is the process with regard to Central and Eastern Europe that—

Chairman LAFALCE. I don't know much about this administration's foreign policy process. That is all I will say.

But I do know, say, the Carter administration had a human rights working group, and that was chaired by Warren Christopher. Do we have a privatization working group, and is there any specific chair of it?

Ms. LANCASTER. Could I answer that maybe?

Chairman LAFALCE. Sure.

Ms. LANCASTER. Because I think you are speaking more broadly than Eastern Europe.

Chairman LAFALCE. Oh, yes. Exactly. I am not just talking about Central Europe, I am not just talking about NIS, I am talking about privatization globally.

Ms. LANCASTER. There is not to my knowledge any such group. There are interagency for where privatization and other international economic issues can be and are discussed.

One of them is chaired by Larry Summers, the NAC.

Chairman LAFALCE. What is that?

Ms. LANCASTER. The National Advisory Committee—I am not sure I have the full name. Everybody knows it by the NAC. National Advisory Committee on—

Ms. SEIBER. International monetary and financial policy.

Ms. LANCASTER. It meets periodically. It does include representation from the State Department, from USAID, chaired by Treasury and a whole host of other agencies.

Chairman LAFALCE. International monetary and financial policy is a very important, but very broad, subject. I would imagine the issue of privatization probably doesn't consume that much of its time or much less the concept of socioeconomic justice.

Ms. LANCASTER. I haven't been present at every meeting. I have not heard that such an issue has been discussed.

Chairman LAFALCE. Also, we have tended at this meeting because of the presence of Mr. Johnson and Mr. Simons to focus in on Poland, Hungary, Czechoslovakia, Russia, et cetera, but there are a whole host of other nations across the globe undergoing very important privatization. You know, Mexico is one. There are countless others.

The process is very well advanced in Chile, Argentina, et cetera, et cetera. Of course the more advanced an economy, the higher our expectations could be of them.

As a matter of fact, I think within the State Department, the more civilized a country, the higher standards we would expect. The less civilized a country, the greater work to be done. But our expectations would not be as great, at least in the short-term.

So I am a bit sorry that we have had so much focus on the formerly centrally-planned economies, because we have an awful lot of other economies, too, that are much more mixed and could have expected more.

Who is most concerned? Is there anybody in the State Department that is concerned about privatization outside of your areas of jurisdiction, Mr. Johnson and Mr. Simons?

Mr. JOHNSON. I don't think that privatization per se would be the focus of attention, because that issue normally would arise in connection with assistance programs, in other words, with our activities.

So you would, I think—there is no real counterpart to Tom and me for the other areas of the world.

Chairman LAFALCE. I wonder if there shouldn't be?

Mr. JOHNSON. I don't know. AID might have a different view on that point.

Ms. LANCASTER. I am not sure how candid I should be.

Chairman LAFALCE. Why don't you try being fully candid?

Ms. LANCASTER. I think in USAID, we probably are the agency that focuses most on privatization and we have programs in all kinds of places throughout the world, in Africa, in Latin America, in Asia.

I think that probably we would be the place where the concerns would be the greatest in terms of our bilateral programs. I am not sure whether Treasury gets very much involved in the issue in relation to its responsibilities for the multilateral development banks.

Chairman LAFALCE. That is another thing too I wanted to ask Dr. Summers, if he ever calls all of the U.S. executive directors in for a meeting and says, OK, let's talk about the issues as to what we ought to be doing in the Asian Development Bank.

A lot of privatization—we haven't touched Asia—that is going on all over the place, Singapore, Thailand, and Malaysia, you name it. It seems to me we need somebody in the State Department.

Do we have anybody in the State Department concerned about privatization efforts in Asia?

Mr. JOHNSON. I don't know the answer to that, Mr. Chairman. My guess would be that in Asia, if we are looking at privatization efforts as a matter of U.S. Government policy, that it would more likely fall in the economic bureau where there is an Assistant Secretary for Economic Affairs who was responsible for economic issues in the building. But—

Chairman LAFALCE. See, now it is of some cause for concern to me. I consider you to be outstanding representatives of the U.S. Government, most concerned about privatization and unaware if there is anybody within your own Department concerned about privatization in a fairly important continent: Asia.

Mr. JOHNSON. But there really isn't a counterpart, Mr. Chairman, to the kind of program that I have, for example, in Central Europe where certainly privatization is—

Chairman LAFALCE. Well, theoretically perhaps there isn't, but functionally it seems to me they ought to be concerned.

Privatization is a great phenomenon now in Asia. It is not a little phenomenon, it is a tremendous phenomenon.

Ms. LANCASTER. If I may, Mr. Chairman, I think we at USAID are in some sense part of the State Department. We do report to the Secretary of State.

But I think because we are probably the most actively involved in the issue of privatization throughout the world, insofar as we

provide assistance on a bilateral basis, so that you would find I think the most concern and expertise in our agency, and I think that that is the connection, is the bilateral assistance program.

Chairman LAFALCE. What are we doing to measure the success for privatization say in Latin America and Asia?

What measurements do we have—do we expect more of those countries than we do of Russia, than we do of the Ukraine?

Ms. LANCASTER. Well, there are two different questions here. Whether we expect more is one. We are operating I think in some ways in an easier context.

Chairman LAFALCE. Well, I asked about measurements for success.

Ms. LANCASTER. I will come to that.

Chairman LAFALCE. Part of measurements for success are expectations.

Ms. LANCASTER. If I may make two points.

In some ways we are operating in an easier environment in these countries, because they were never command economies. So, they were always private activities. Land had a market value. The legal system had some basis for contract law and private property.

So in one sense privatizing state-owned enterprises in these countries I think requires rather less of an effort than is required in Eastern Europe and the former Soviet Union.

On the other hand, in some ways we are operating in a more difficult environment. That is particularly the case in Africa where you don't have capital markets and you have often subsistence economies in the rural areas and people with very little—often, little education and little capital.

So they can't easily participate, as I think I sensed you would have liked to have seen in other parts of the world in the privatization activities. So, that we are getting into very different conditions here.

Chairman LAFALCE. No question. I understand that.

Ms. LANCASTER. I have to say that, to my knowledge, there has not been an effort to look at all of our experience worldwide, and to measure that experience, not just in terms of the numbers of state-owned enterprises privatized, but also in terms of the impact on productivity, on employment, on income, and so on, all of the things that we have been talking about in a general sense here.

We do have some studies that we have commissioned on experiences in individual countries. There is quite an interesting one on Zambia, for instance. But we have not I think developed what I hear you saying is the kind of measures that you think rightly ought to be developed.

We are concerned, if I may just add one more point, much more broadly about developing, to the extent possible, quantitative indicators that are meaningful and allow us to measure the impact of what we do, not just in this area, but in other areas.

But I think our push here is just beginning. This is something that is going to be part of our overall program. So, I think we have a job to do in this area too.

Chairman LAFALCE. I agree with you, Dr. Lancaster. Our push is just beginning, we have a job to do, but what I am fearful of is

privatization is proceeding so quickly, and I don't want to impede that.

But, unless we go very quickly, it is going to be too late. I just don't think that people in the administration have focused in on the import of this. But we have this miraculous moment in history, and if it goes through our fingers, and it has fallen through our fingers somewhat already, and the question is can we grasp it still.

To the extent that it has fallen through our fingers already, can we go back? Can we either reprivatize or in some way through some policy efforts mend the problems which were not dealt with in the initial privatizations? I don't know. That is a separate set of questions.

But Mr. Johnson and Mr. Simons in particular, although AID is part of State too, I remember a hearing I had about human rights conditions in Mexico, and I had the State Department human rights person in, I have forgotten the person's name; it was a young lady, but it wasn't just one person.

It seemed to me at that time—maybe I am not being fair, but I think I am—that there was no concern given a determination of human rights as to what those governments do to try to improve the economic life of the people of the country.

My God, being able to eat is a human right. Being able to own property is a human right. Having a fair share in the wealth of the society is a human right. When we discuss human rights, too, I hope we will talk about economic empowerment.

I always thought that Chile got short shift because we only focused in on certain aspects of human rights. Very important aspects, but we didn't focus in on what the economy of its country was doing and whether the economic gains the country was making was being diffused to the rank and file of society, and I thought that we would not have been quite as harsh on Chile if we had factored that into the equation.

I think they were doing better than other countries in that effort, and that ought to be part of the measurement criteria in assessing privatization, if indeed we are assessing it. I don't know that we are assessing it, other than by numbers.

Mr. JOHNSON. Mr. Chairman, I would say that as we look at Eastern Europe, privatization is only a part of the program that we are conducting there.

That through other steps we are taking in order to open up the economy, among them the enterprise funds, but not limited to that, we are working to enable people to participate in economic life.

We are involved in projects ranging from mapping and helping to develop a titling system for agricultural lands so that the people who come off cooperatives will be able to have a claim to their land and entering the transactions for land.

I would say too that we don't look at privatization itself only as a fact, we look at it as the beginning of a process. So, that if we can create within the economy the conditions under which you have a banking system, the conditions under which new economic activity is beginning to employ the people in the economy who are no longer working in the state sector, because the private sector now accounts in most economies in Eastern Europe for over 50 percent of GDP, then it seems to me that we are participating in an

effort which has, as its objective, the overall economic development of society.

Privatization is only one part of our effort to try to make that happen.

Chairman LAFALCE. I appreciate that. I asked about mechanisms for the discussion of privatization within the U.S. Government. It seems to me we have very few.

What about international mechanisms under the auspices of the United Nations, under the auspices of the OECD, et cetera? What is going on globally to discuss the concept of privatization and to fashion coordinated policies with respect to privatization, if anything; should there be, and then what would the ingredients of that be?

If there are such forums, mechanisms, discussions, principles, is this concept of socioeconomic justice, economic empowerment part of it?

Ms. LANCASTER. Maybe I can take a crack at that, Mr. Chairman.

I am told that UNCTAD, the United Nations Conference on Trade and Development, has a working group on privatization. We are a member of the UNCTAD, as are I think probably 160 plus other countries, and that USAID has been head of the U.S. delegation to that working group over the last several years.

Chairman LAFALCE. Who has been?

Ms. LANCASTER. My agency, USAID, as the U.S. agency representing the United States.

Chairman LAFALCE. Who within AID?

Ms. LANCASTER. That, I don't know. Whether my staff knows or not, I don't know. Oh. Well, the person is right back there.

Chairman LAFALCE. Perhaps you have not gotten too many reports from her then on their work.

Ms. LANCASTER. I haven't gotten any reports on their work. I would just add that there are other international mechanisms where these issues are—I mean I don't know that privatization is being discussed, but there are a number of other places where it might be.

The Development Committee of the World Bank, that is a group of—

Chairman LAFALCE. We are only speculating as to where they might be and we don't know that they are, then obviously if it hasn't come on to our radar screen, they are not doing a very effective job.

Ms. LANCASTER. All right. If I may, I have a couple of words here about what has happened. The report says that working with delegates from every continent we, the United States, ensure that the report issued by the UNCTAD working group on privatization included a section, social impact, and support measures stating that social considerations are an essential component of the process of privatization and need to be built into the process from the beginning, that employment and social welfare need to be addressed, and that job security be promoted to protect employment and its conditions for a specified period after privatization.

We, USAID, are reviewing our policies to ensure they take into account the social dimensions of privatization and we will continue

to assist countries who are considering options to deal with the problem.

Chairman LAFALCE. Well, I have high regard for each of you individually. You all have outstanding backgrounds and reputations, but it seems to me, my conclusion on the basis of this hearing, is that this issue has not really come to the radar screen of the U.S. Government, that there is virtually no policy that is being pursued and implemented with any vigor whatsoever to ensure that we get maximum feasible socioeconomic justice achieved as part of the privatization process.

I could be wrong in that, but at least that is unfortunately my judgment. If you think that the issue is important, forget about whether my judgment is right or wrong, but for God sake do some more about it than you have in the past.

Thank you very much.

[Whereupon, at 12:10 p.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

OPENING STATEMENT
OF
THE HONORABLE JAY DICKEY
Fourth District - Arkansas

BEFORE THE SMALL BUSINESS COMMITTEE
REGARDING A HEARING ON THE PRIVATIZATION PROCESS
MAY 12, 1994

Mr. Chairman, I wanted to take a moment to thank you for holding this second in a series of hearings on the topic of privatization efforts, especially the nations of Eastern Europe and the Former Soviet Union.

I believe this discussion is of utmost importance because the former Soviet Union, Mexico, Central Europe, and even Asia are making every effort to privatize their giant state-run economies, while this Congress seeks to nationalize a full 14% of our nations GDP.

I had the opportunity during the debate over the North American Free Trade Agreement, to travel to Mexico City and meet with their President and Cabinet. I learned that Mexico, a nation who only a few years ago burned our flags in the streets, had undertaken one of the most massive privatization campaigns in modern history. 94% of nationalized businesses were sold to private investors and corporations over the past eight years. This opportunity provided investors the ability to make radical changes in market strategy and to secure their capital investments. Thus providing a stable tax base, creating a strong professional middle class, and allowing the government to run a budget surplus. Additionally, this policy has increased export capability, reduced inflation, and encouraged international corporations to invest in Mexico. True, there is a disparity between the industrialized cities and the rural outlands. Now there is money in the coffers to do something about it.

I welcome the panel before us and look forward to hearing their testimony.

Thank you.

STATEMENT OF REP. JOHN J. LaFALCE

COMMITTEE ON SMALL BUSINESS

HEARING ON

"PRIVATIZATION: "THE GOALS AND IMPLEMENTATION OF U.S. POLICY"

May 12, 1994

The Small Business Committee meets this morning to continue its examination of the global privatization process and its implications regarding business opportunity and economic equity in the societies involved.

On April 14, the Committee heard from witnesses representing practitioners, academics, and consultants. This morning we welcome Administration witnesses as we focus specifically on U.S. privatization policy: what our goals are and how we implement them.

Privatization is a central tenet of the economic policies of more and more countries around the globe, particularly since 1989 when Eastern Europe and the former Soviet Union began to transform their centrally-planned economies to ones that are market-oriented. However, there appears to be more concern with the number of privatizations as a measure of success--more than 8,500 in over 80 countries since 1980, according to the World Bank--than with the quality and effects of the conversions. Too much is at stake to make this merely a numbers game.

In my view, the way in which privatization takes place is at least equally as important as the fact that it occurs. Privatization can be a vehicle for either distributing the wealth of a society more equitably or for unfairly concentrating that wealth.

U.S. policy should recognize such differences, and strive for the most equitable distribution of existing and potential societal wealth as is feasible. I am concerned that U.S. policy, as currently conceived and implemented, does not do that, and may concentrate its efforts on the objective of privatization itself, with little, if any, attention to who benefits and who loses in the process. We see too much of the so-called nomenklatura or patron privatization which excludes adequate opportunity for a broader-based process that would enhance the socio-economic conditions of the greater body politic--what I would call: Empowerment Privatization.

Our policy must bring certain standards to bear, and those standards must reflect the particulars of a country's experience. Privatization comes in many forms and uses an array of methods--bids, shares, auctions, coupons, etc. Perhaps no one method is inherently preferable. Moreover, the conditions country-by-country are vastly different. As Poland's former Finance Minister Balcerowicz recently observed, how privatization functions in a country depends on variables such as micro and macro economic conditions, debt, human capital and their

interactions with political conditions. It seems reasonable, then, to have multiple criteria by which to measure success depending on the situation of the country.

However, we must not make the mistake of using criteria that only look through the prism of economic data. At our last hearing, one witness argued that Russian privatization has been a huge success because "it has been a large transfer..(and) there are very many owners now in Russia." In contrast, another witness pointed out that, while Russia's experience has been quantitatively impressive, the economic figures mask the less positive qualitative features of privatization. He noted that "the promise of fair property distribution among the population was not being realized, and the inadequacies of the privatization program contributed importantly to the worsening of Russia's economy and to the political conflict." This week the Financial Times reported a deep crisis in Russia as output has plunged 25 percent. According to the reported poll, a majority agreed that "privatization is legalized theft" and two-thirds of respondents believed that privatization was "undertaken for the benefit of nomenklatura and criminals."

Similarly, the New York Times reported in October 1993 that privatization in Mexico has increased competition among the handful of families bying to be Mexico's wealthiest clan. According to a quote in the report, "The booty of privatization has made multimillionaires of 13 families, while the rest of the population--some 80 million Mexicans--has been subjected to the same gradual impoverishment as though they had suffered through a war." While privatization income helped Mexico's Government service its debt, it also caused 400,000 Mexicans to lose their jobs.

The United States and other Western governments have offered enthusiastic support for privatization efforts. But general observations of this nature must be coupled with a note of caution. Such caution is particularly important given what may be increasing skepticism about our own motives. In Russia, for instance, privatization policies have become linked in the minds of many with the United States because of U.S. officials' highly visible and public support for economic reforms. A number of Western advisors to the Russian Government, reported one hearing witness, are viewed by Russian citizens as representing U.S. and other Western business and commercial interests. In fact, in February this year, the Wall Street Journal reported that nearly 50 to 90 percent of the money in any given U.S. aid contract directed to assist economic transformation in Russia comes back to the United States in the form of consultants' fees. Given the perceived link between reform and Western business interests, it is plausible to expect that the United States could share the blame for economic failures and dashed expectations that would result from a privatization effort not sufficiently driven by concerns for equity.

Similarly, press reports this week announced enormous public disillusionment in Hungary with economic reform--and a resulting

nostalgia for communism that led to the former communists, now the Socialist Party, winning 33 percent of the first round in parliamentary elections. A similar resurgence of communist support has occurred in Poland and Lithuania. This is certainly not what U.S. policy on privatization has been trying to achieve.

It is time for us to ask some probing questions about U.S. policy on privatization and how we implement it. In particular, we must assess whether we are giving adequate attention to analyzing the actual results of privatization efforts and determining who in these societies is benefiting. We must also determine who in the United States benefits from tax dollars going for privatization overseas, and whether such commercial concerns have too great an influence in the formation of our policy or nonpolicy. Our criteria for success and for failure must be made more explicit, and it is time to make any mid-course corrections in our policy efforts that are warranted.

We are pleased this morning to welcome Administration witnesses who are knowledgeable about, and intimately involved with, privatization efforts worldwide. We will begin with **Dr. Carol Lancaster**, Deputy Administrator for the Agency for International Development. Next is Under Secretary of the Treasury for International Affairs **Lawrence H. Summers**.

We also welcome two Ambassadors from the Department of State: **Ralph R. Johnson**, Coordinator for East European Assistance, and **Thomas W. Simons, Jr.**, Coordinator of U.S. Assistance to the New Independent States. We look forward to your presentations.

Statement of Representative Rob Portman
on
Federal Efforts to Promote Privatization
Committee on Small Business
May 12, 1994

Mr. Chairman, thank you for calling this hearing to consider the role of small business in efforts to promote privatization.

Privatization presents small business with unique opportunities for development and expansion. These opportunities for growth are especially apparent with the conversions of the economies in Eastern Europe and the nations of the Former Soviet Union (FSU).

There are also benefits in privatization for the participating nations in building a stronger economic base through developing new industries and encouraging exports.

I am eager to learn more about the effects of privatization on small business as our world economy becomes increasingly globalized. I look forward to hearing the testimony of our distinguished panel of witnesses today.

Thank you, Mr. Chairman.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
May 12, 1994

HEARING ON PRIVATIZATION

Mr. Chairman, thank you for holding this hearing on U.S. policy goals in fostering privatization, particularly in the nations of Eastern Europe and the former Soviet Union.

I certainly share your belief that privatization is one of the pillars upon which the transformation of those economies must be built.

I also feel we need to make a greater push toward privatization in this country.

Mr. Chairman, thanks again for this hearing and I look forward to hearing from today's witnesses.

Statement of The Honorable Ralph R. Johnson
Before the
House Subcommittee on Small Business
May 12, 1994

Mr. Chairman and members of the Small Business Committee of the U.S. House of Representatives, I am pleased to appear before you to discuss the experience of our assistance programs in Central and Eastern Europe with privatization. I want to begin by expressing my praise for the work of the Central European Small Business Enterprise Development Commission, established at your initiative, Mr. Chairman. The programs created by the Commission in Poland, Hungary and the Czech and Slovak Republics are enjoying strong host government support, and are making an important contribution to the development of a viable small business sector in these countries.

Mr. Chairman, in the context of our assistance programs we have used a narrow definition of privatization policy: we seek to promote as rapid a transfer as possible of all non-strategic assets from public to private ownership. Our policy includes four components:

1. We strive to ensure a rapid and transparent system of negotiating actual sales by helping create the needed legal structure for transfers; we seek to group sales into "mass privatization" schemes, training host country staff in the skills needed for the actual sales; we provide technical

advisors in accounting, investment banking and corporate law in order to help conduct mass privatization programs.

2. We work to help governments facilitate the liquidation of non-productive firms through bankruptcy, state company break-ups and asset sales.

3. We are helping to develop local capital markets, voucher fund and share privatization programs and employee stock ownership plans to augment local investment in privatized firms and assets.

4. We put special emphasis on bank privatization and the creation of local investment banking capabilities to ensure success in the post-privatization period, since the process of mergers, liquidations, etc., will continue well beyond the main privatization program and must be managed through the local financial sector.

At this juncture I would like to summarize some of the results of our experience with each of these approaches.

First, the cost of assisting with reform of the legal structure in Central and Eastern Europe has varied from \$50,000 or less in Bulgaria and Albania, to about \$1.5 million per country in Latvia, Estonia, Slovakia and Poland. All of these programs have been productive. On the other hand, we have found the training of host country staff, where there was no pre-existing expertise, to be problematic, in part as a result of the lack of experience in these nations, and in part as a result of the short time available for staff training in a rapid privatization process. For this reason, our technical assistance with mass privatization has been crucial. Examples of success stories in this activity are Estonia, the Czech Republic, Hungary, Lithuania and Poland. Slovakia, Romania and Latvia are now starting similar programs.

The cost of putting a substantial transaction team in a country varies from about \$1.5 million to \$4 million per year depending on the size of the project. These teams can typically handle about 150-200 major transactions per year in cooperation with host country with host country staff. In our experience, combining mass privatization with other means of privatization, and putting our programs together with those of other donors, and assuming strong support from the host

government, the cycle of privatization for state holdings lasts about 3-5 years. For example, the Czech and Estonian programs, both of which have featured the U.S. as a lead donor, will be completed in FY 1995. Hungary and Poland will not be far behind.

A significant problem we have encountered is the shortage of high quality U.S. contractor staff to handle the demand for experts now arising in Central and Eastern Europe, the NIS and other parts of the world. Obviously, lack of host government support for privatization, sometimes because of the fear of resulting short term unemployment, is another significant obstacle to rapid progress.

With regard to our second approach, that is the liquidation of non-productive firms through bankruptcy, we can claim only modest success. Privatization through liquidation has not been a preferred option on the part of governments in the region, although the governments of Poland and Hungary have made substantial use of this approach. In these latter cases, firms have typically not been totally abandoned, but split into more viable pieces for sale. The backlog of bankruptcy cases throughout CEE is substantial, raising a potential problem over the longer term for the courts and banks.

Programs under our third area of emphasis, the development of local capital markets have brought advisory teams to critical local institutions throughout the region to assist in the formation of local capital markets. Typical teams comprise three professionals at a cost of about \$500,000 per year. This is a "second generation" program, since it requires as a prerequisite a commercial banking structure. The major problem here is the shortage of domestic capital in Central and Eastern Europe, and the lack of popular understanding of equity ownership. Nevertheless, we have had some important successes: In Hungary, a US-assisted ESOPs program has resulted in over 100 major firms transferring ownership to employees - one of the most successful such programs in the world. The stock exchange we have assisted in Warsaw is one of the most visible emerging markets in the region. Local ownership funds in Romania, the Czech Republic and Poland are succeeding with our help.

Bank privatization and the creation of local investment banking capabilities is the last frontier in Central European privatization. We and other donors probably underestimated its importance early in the transition process. Work in this sector includes the development of central bank capability and a payments infrastructure to sustain the banking system; the

restructuring or sale of state bank debts to allow privatization; the negotiation of bank sales; bank training to retrain personnel for private banking, including training in investment banking. We will invest about \$20 million in our bank training effort over a five year period.

While the results of bank training so far are encouraging, problems remain. Important political issues surround state bank debt consolidation and write-offs. There is often considerable sensitivity about the role of foreign banks. Central bank reform often comes slowly. The costs of bank consolidation and privatization, including World Bank loans, can easily be \$300 million per country or more. Our finance advisory teams cost about \$2 - \$4 million per year, and are typically needed for 2-3 years, assuming the right policies are in place to achieve financial sector restructuring.

Our most successful efforts to date have been in Poland, where USAID, the EBRD and the World Bank are working together, and the Czech Republic, where strong local leadership has allowed USAID to play a key role with specific institutions.

In the broader sense, privatization involves the successful development of indigenous private enterprise, not just the transfer of the state sector to private hands. In this respect, the balance of our economic restructuring programs have been extremely important. This part of our assistance effort accounts for about three-quarters of our resources. In includes such innovative programs as the Enterprise Funds, managed by private sector boards. In the final analysis, the development of a strong private sector in the countries of Central and Eastern Europe is crucial to their economic success. Our programs are helping them put the necessary building blocks in place for the operation of free-market economies, but the political determination of the countries in the region is the crucial ingredient for success.

TESTIMONY OF CAROL LANCASTER
DEPUTY ADMINISTRATOR
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

WASHINGTON, D.C.
MAY 12, 1994

Mr. Chairman, and members of the Committee, thank you for the opportunity to appear and discuss USAID's role in privatization efforts around the globe. Privatization, and the related questions of social equity and the role of small business, are particularly important as we see so many governments attempting to move away from their traditions of inefficient state-dominated economies.

But privatization, like any other aspect of development, must not be considered in a vacuum. It is a key element in promoting free markets and economic growth in many countries. Economic growth, in turn, is part of the Clinton Administration's approach to promoting sustainable development which is focused on four priorities: promoting broad-based economic growth; supporting democracy; protecting the environment; and, stabilizing population growth and promoting health concerns. Moreover, sustainable development programs are a part of our policies of preventive diplomacy. Problems of rapid population, widespread environmental degradation, the AIDS pandemic, the need for participatory governments, and hunger can lead to political and economic instabilities, conflict and chaos - as we have seen so often in the recent past. It is cheaper and more humane to do what we can now than to have to finance the costs of relief and watch the suffering they can cause later.

By helping nurture democracies and free market systems, we are also creating more immediate benefits for the United States. Stable participatory government and open trading systems mean more jobs for Americans, and the continued growth of exports to the developing world has played a crucial role in this nation's economic recovery. In the future, the developing world will become even more important to our domestic well being, when we consider that by the year 2000 four out of five consumers will reside in the developing world.

In an effort to make our assistance more effective, the Clinton Administration has also submitted the Peace, Prosperity and Democracy Act of 1994 (PPDA) to Congress. This legislation to reform our assistance programs is critical in light of the changing realities of

the post-Cold War world. This "charter" legislation would replace the badly outdated Foreign Assistance Act of 1961 and is the product of a collaborative effort involving the Administration, the Congress, and the development community. It is designed to serve as an effective policy framework for our foreign policy objectives for years to come.

This new legislation focuses on producing measurable results, brings increased accountability to assistance programs, and is built directly upon the principles of sustainable development. The PPDA places much needed emphasis on participation and building development programs from the bottom-up. This emphasis on collaborating with the people we are trying to assist will result in economic and social programs that truly reflect the needs and capabilities at the local level, and will offer important benefits for small businesses, community organizations, and traditionally disenfranchised groups such as women and rural agricultural producers. I look forward to working with you on this important legislation

Privatization and Broad Based-Economic Growth

Privatization, in effect, is having powerful affects around the globe. It is the democratization of the marketplace -- and in the tens of thousands of new businesses, the sense of empowerment it is giving to new owners of private enterprises is producing lasting and impressive results.

Privatization of state-owned enterprises, when well conceived and properly implemented, fosters efficiency, encourages investment, new growth, and employment. This in turn frees tight public resources for valuable investments in people and infrastructure. In Latin America the persistent deficits of many state enterprises effectively crowded out expenditures in education, health care, and other legitimate government functions. However, in countries like Guatemala we see the government now devoting a greater share of its resources to these sectors. In The Gambia, after a successful period of economic reform and privatization, the country is increasing its budget for population, education and health programs. The greater efficiency of markets that results from privatization can also produce significant growth. For example, privatization of the fertilizer monopoly in Bangladesh led to the entry of 50,000 small-scale retailers and a 10 percent drop in the price of urea, a widely used fertilizer. In turn, both domestic food production and fertilizer imports from the U.S. increased. In the case of India, elimination of the state trading and import monopoly not only allowed an expanded private sector role in the import, distribution and sale of food items, it led to lower food prices to the consumer. As a general premise, a World Bank report illustrated that, in ten of twelve cases studied, domestic welfare significantly improved after privatization.

In the last decade, USAID was a leader in introducing privatization as a means of creating economic opportunity and growth in developing countries. Most developing countries now recognize that privatization has an important role to play in improving their economic performance. Currently, USAID continues to support privatization with technical

assistance, credits and policy advice to governments. USAID is also working to address the social issues which accompany privatization and structural adjustment of developing economies.

Small Business and Privatization

I know that this Committee is concerned with the well-being of small businesses. We too share that concern. In countries where the state controls the economy, barriers to entry, and controls on credit, prices, and factors of production stifle the growth of small business. Our objective is to create an economic, political and social environment where small business flourishes. By their very nature, small businesses lend themselves well to privatization. In fact, they are usually the first in line in the privatization process. In Russia, some 125,000 small businesses have already been privatized. Small firms can also lend themselves to the transfer of ownership to managers or workers, a practice common in Eastern Europe and in Russia. Such transfers can preserve jobs, avoid the negative impact of closings, and create strong incentives to improve productivity.

Frequently the large state-owned firms are conglomerates, controlling many subsidiary small businesses. The parent firm set production goals, prices of inputs, distribution channels, and made nearly every other decision. In that environment, no small business can grow. A usual first step in the privatization of the large firms is the divestiture of small businesses, freeing those enterprises from control of larger firms.

Privatizing large firms also has proven a boon to small business development. New investment in the larger privatized firms generates demand for inputs from suppliers -- both small and large. This increased demand for goods and services creates jobs in the smaller firms. Each job created is one more step toward economic and political sustainability.

The work doesn't end when we turn the firm over to private hands. Providing the new owners with the financial, technical, managerial and other needs of a small business is also one of our objectives. Privatizing the firm may well be the easiest part of the process. The privatization process must be accompanied by the creation of economic and political institutions necessary for the robust growth of small businesses. Around the world the focus of our efforts to support market-oriented economic growth is on small businesses, and what we can do to make it succeed. Thus USAID's programs not only include providing technical assistance to privatize the firms, they also help build what we call the "enabling environment" for the private sector. Activities can include:

- building local capital markets in order to broaden ownership, generate new capital, and allow the trading of financial assets;
- developing the legal and regulatory structures that ensure competition by establishing commercial, anti-monopoly, tax, employment, and investment laws; and

- assisting financial institutions build their capacity.

In some countries, particularly those with high and middle-incomes, privatization takes place in a context where the private sector is already thriving and much of the legal framework to support it is already in place. In other less-developed countries, particularly in Africa, the enabling environment is not in place and, thus, USAID assistance also helps establish the regulatory environment and institutions in which the private sector can thrive. This has been the focus of our assistance in The Gambia, Senegal, Tanzania, Zambia and Zimbabwe.

How well we succeed is dependant on many variables. Reform of fiscal and monetary regimes must proceed in tandem with all other reforms. Interest rate and foreign exchange rate systems that reflect scarcities must be put in place. A stable, convertible currency is important. Capital and financial markets must be created. Laws must be instituted and enforced, covering property, contracts, labor, customs and a host of other fundamental areas critical to ensuring a predictable and transparent regulatory environment for investors. All those factors constitute, what many refer to as, the enabling environment for growth. As with any environment, it must be addressed as a comprehensive whole, understanding that its functions and relations are highly interdependent.

Lessons From The Field

From Africa to Asia, from Latin America to the Russian Far East, the U.S. government is providing assistance in many of these areas. I have attached some of our activities in a number of countries around the globe in privatization to give you a feel for what we are doing. But I would like to focus particularly on our experience with privatization in Russia and the Newly Independent States and Central and Eastern Europe.

Some of the most impressive progress of foreign assistance programs in Russia and the Newly Independent States and Central and Eastern Europe to date has been in privatization and market reforms. This progress, particularly in Russia, has been remarkable. Two thirds of all small shops or about 70,000 businesses have been privatized; 50 percent of all medium and large scale enterprises -- some 8,500 -- have been auctioned, and 40 percent of Russia's industrial labor force is now working in the private sector. Amazingly, some 40 million Russians have become shareholders in private companies. The Economist recently wrote: "the privatization program is so popular that even the Communist Party dares not challenge the need for it, merely the way in which it is done."

Just as job creation in the United States is most often generated by small businesses, we are targeting support to emerging small businesses in Eastern Europe. Almost \$200 million has been leveraged from other investors by Enterprise Fund investments of \$290 million in over 3,000 new private enterprises in Central and Eastern Europe. An estimated 20,000 new jobs have been created. Special initiatives by the Polish, Hungarian, and Bulgarian Funds are addressing the needs of the smallest enterprises, offering loans as low as

\$1,000. In Poland, 2,400 loans have been already been awarded under this initiative from 12 loan application centers throughout the country. The Czech and Slovak Funds have invested \$14 million in small and medium enterprises, established small loan programs in both republics, and engaged the European Community's foreign assistance program officials in discussions that may lead to a joint investment program for the Czech Republic.

Small business is a particularly critical for generating new jobs. The privatization program demonstrates the potential for small business success - two thirds of all small shops in Russia have been privatized. Our technical assistance, training and exchange programs are developing business services, information on markets, and exposing entrepreneurs to U.S. ways of doing business.

We are helping to establish a business environment overseas that will lay the conditions for expansion of American trade and investment, thus creating American jobs, and ensuring stable democracies and economic linkages to the European Union and the United States.

Moreover, even though the reform process is far from complete, it is already changing people's lives. Markets have goods; lines no longer wind along the block and shelves are not empty. Entrepreneurs have set up businesses everywhere, focusing first on trading and now some moving into manufacturing.

For the individual, this has meant increased choice -- the chance to buy shares of stock in the bakery down the street, to buy an apartment, to change jobs. In a sense, it has meant a democratization of the economy, giving individuals a personal stake in the economy for the first time, as a shareholder, homeowner or small shopkeeper.

But privatization is not enough in itself to turn these societies into more prosperous ones. A second phase post-privatization effort is focusing on the legal, regulatory and financial systems needed for private businesses to thrive and the public interest to be protected: securities markets and SEC regulatory systems; commercial banking and other financial structures; and, corporate governance and public disclosure regulations. U.S. housing advisors have worked with Russians in setting up legal structures which have enabled the privatization of millions of apartments, creating the beginning of a private housing market, and allowing people to own their own homes. U.S. farmers are working with farmers across the NIS to improve production, storage and marketing; retired executives are working with newly privatized companies on new product ideas and joint ventures with U.S. firms.

In support of privatization programs, USAID is following through on the strategic approach, instituted last year, of strengthening East European institutions that are critical to implementing priority reforms. We are strengthening the financial sector in a number of ways. For instance, hundreds of bankers have been trained in Poland and the Baltics, which in turn has helped the Polish Central Bank develop its capacity to supervise private banks,

and has facilitated commercial bank privatization. USAID is also playing a key role in the regulatory development and expansion of Eastern European capital markets. We are helping with emerging exchanges that allow citizens to trade their vouchers and engage in share issuance programs that can finance new businesses when bank loans are unavailable or too expensive.

We recognize that change has not come without some pain. Goods may be on the shelves but in many places prices beyond reach. Unemployment, while still low in many countries, is increasing. Services and the sense of security provided by the welfare state are disappearing. We are acutely aware of problems in the business climate which make it difficult for both domestic and foreign investors to invest and create new businesses which will be the key to addressing employment needs. Taxation can be onerous, duplicative, and make it nearly impossible for investors to operate profitably. This can be especially true for small businesses operating on small margins. We have placed high priority on helping Russia rationalize its tax and expenditure system. Technical assistance at national and local levels of government is helping tax planners understand the impacts of alternative tax systems on various actors in a market economy, and is helping put in place the administrative machinery needed for fair and effective tax administration and collection.

Privatization With A Human Face

The issue of the social costs associated with privatization is important for several reasons. If we do not consider the social impact of privatization, these efforts may be undermined by political resistance to implementing them. Secondly, the provision of assistance for laid off workers is intrinsically important, under any circumstances, as a matter of social and economic justice. Lastly, unlike the majority of Western industrialized nations, most developing and transitioning economies do not possess systems which offer social services and financial assistance to redundant workers, many of whom depend heavily on their government employers.

The way privatization is implemented can ameliorate the impact of dislocation. For example, in Poland the preferred method to privatize medium-sized businesses is transfer of ownership to employees and managers, providing for job security. World-wide, most small businesses are privatized this way. Well designed severance schemes, like Bolivia's, have succeeded in encouraging enough workers to leave voluntarily, while providing adequate incentives to retain productive workers. Credit, and credit guaranties, for business start-up are being used to help former employees start their own businesses.

Over the last 18 months USAID has chaired the U.S. Delegation to the United Nations Conference on Trade and Development Working Group on Privatization. Working with delegates from every continent, we ensured that the report issued by the Working Group included a section "Social Impact and Support Measures," stating that: social considerations are an essential component of the process of privatization and need to be built into the

process from the beginning; that employment and social welfare need to be addressed; and, that job security be promoted to protect employment and its conditions for a specified period after privatization. We are reviewing our own policies to ensure they take into account the social dimensions of privatization, and we will continue to assist countries who are considering options to deal with the problem.

In Conclusion

Privatization is a critical element in the economic transition underway throughout the world. It is important to the success of that transition, as well as to build support for stable economies and participatory political systems. But privatization can be complex, difficult and painful. USAID will continue to support foreign governments in these efforts with the hope and belief that effective economic transformation promises a better future for us all.

I thank you for the opportunity to share these thoughts with you, and I would be happy to answer any questions you may have.

COMMENTS BY AMBASSADOR THOMAS W. SIMONS, JR.
COORDINATOR OF U.S. ASSISTANCE TO THE NEW INDEPENDENT STATES
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
MAY 12, 1994
"U.S. POLICY GOALS IN FOSTERING PRIVATIZATION"

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I WELCOME THIS OPPORTUNITY TO APPEAR BEFORE YOU TO DISCUSS U.S. POLICY GOALS IN FOSTERING PRIVATIZATION. FROM THE OUTSET CONGRESS HAS PROVIDED CRUCIAL SUPPORT FOR PRIVATIZATION IN THE NEW INDEPENDENT STATES. THE COOPERATION BETWEEN CONGRESS AND THE EXECUTIVE BRANCH IN THIS HISTORIC ENDEAVOR HAS BEEN VITAL TO THOSE OF US WORKING DAY TO DAY TO PROVIDE ASSISTANCE IN THE NIS AND TO FURTHER U.S. FOREIGN POLICY OBJECTIVES IN THE FORMER SOVIET UNION. I INTEND TO DO ALL I CAN TO CONTINUE TO STRENGTHEN THAT COOPERATION.

I WILL CONCENTRATE MY REMARKS TODAY ON THE RUSSIAN PRIVATIZATION PROGRAM BECAUSE RUSSIA HAS BEEN IN THE FOREFRONT OF PRIVATIZATION IN THE AREA, BECAUSE IT HAS THEREFORE RECEIVED THE LION'S SHARE OF OUR COMMITMENT TO THE NIS SO FAR AND BECAUSE OUR EXPERIENCE IN RUSSIA PROVIDES IMPORTANT LESSONS FOR WORK IN OTHER NIS.

I WOULD LIKE TO ADDRESS SIX TOPICS, IN ORDER. FIRST, WHAT ARE U.S. POLICY GOALS ON PRIVATIZATION IN THE NIS; SECOND, WHAT EFFORTS HAS THE U.S. GOVERNMENT MADE TO IMPLEMENT THIS POLICY; THIRD, WHAT HAVE OUR PRIVATIZATION PROGRAMS COST; FOURTH, WHAT HAVE BEEN THE RESULTS AND SUCCESSES; FIFTH, WHAT ARE THE PROBLEMS ARISING FROM THIS EFFORT; AND SIXTH, WHAT ARE THE POLICY IMPLICATIONS OF THE EFFORT SO FAR.

I. POLICY GOALS ON PRIVATIZATION

PRIVATIZATION IS PART OF A BROADER SET OF ECONOMIC OBJECTIVES THE U.S. GOVERNMENT HAS IN ITS RELATIONS WITH RUSSIA. IN GENERAL, WE WANT TO SEE RUSSIA DEVELOP INTO AN INDEPENDENT, DEMOCRATIC, PROSPEROUS AND STABLE NATION AT PEACE WITH ITSELF, ITS NEIGHBORS, AND THE LARGER WORLD. WE ALSO BELIEVE THAT STABILITY AND PROSPERITY WILL REQUIRE BROAD AND DEEP REFORM IN THE DIRECTION OF DEMOCRATIC GOVERNANCE AND MARKET ORIENTED ECONOMIC MANAGEMENT.

MORE SPECIFICALLY, WE WANT TO SEE CHANGES ON TWO LEVELS. ON THE MACRO-ECONOMIC LEVEL, WE WANT TO SEE INFLATION REDUCED TO NEGLIGIBLE FIGURES, AND WE WANT THE RUBLE TO RETAIN ITS VALUE. ON THE MICRO-ECONOMIC LEVEL, WE WANT ENTERPRISES TO BE RESTRUCTURED, SO THEY WILL INCREASE THEIR EFFICIENCY, AND WE WANT TO HELP RUSSIAN REFORMERS CREATE THE LEGAL, REGULATORY, AND INSTITUTIONAL STRUCTURES THAT FIRMS NEED TO OPERATE EFFICIENTLY AND PRODUCTIVELY. THESE MEASURES WILL FACILITATE

REINVIGORATED DOMESTIC AND FOREIGN TRADE AND INVESTMENT, THUS MAKING ASSISTANCE UNNECESSARY.

THUS THE GOAL OF OUR PRIVATIZATION AND POST-PRIVATIZATION POLICY IN THE NIS IS TO RESTRUCTURE FORMER STATE-OWNED FIRMS AND RAISE THEIR EFFICIENCY. THIS GOAL IS APPROPRIATE BECAUSE GREATER EFFICIENCY WILL TRANSLATE INTO A HIGHER STANDARD OF LIVING AND MORE SECURE JOBS, A GREATER CAPACITY FOR FIRMS AND INDIVIDUALS TO PAY TAXES AND HENCE A GREATER CAPACITY FOR THE DEMOCRATIC STATE TO FUND ADEQUATE SOCIAL SECURITY PROGRAMS AND TARGET THEM AT THE GENUINELY VULNERABLE AND NEEDY. THAT, IN TURN, SHOULD SUPPORT GREATER LONG-TERM POLITICAL STABILITY.

AN ALTERNATIVE GOAL IN OTHER COUNTRIES HAS BEEN TO MAXIMIZE REVENUES FROM THE SALE OF STATE-OWNED FIRMS. SUCH AN OBJECTIVE IS APPROPRIATE IN COUNTRIES SUCH AS MEXICO OR BRAZIL, WHERE MANY STATE-OWNED FIRMS HAD A HIGH VALUE TO PRIVATE INVESTORS HAVE BEEN TAKING THEIR MONEY OUT OF THE REGION ON A VAST SCALE, AND WESTERN INVESTORS. IN RUSSIA DOMESTIC BUSINESSES HAVE CHOSEN NOT TO COMMIT LARGE SUMS TO THE NIS.

THE STRATEGY OF OUR PRIVATIZATION POLICIES IS TO DEPOLITICIZE STATE-OWNED FIRMS. WE WANT TO SEE THE INFLUENCE OF POLITICS GIVE WAY TO THE INFLUENCE OF MARKET FORCES.

THIS STRATEGY ENTAILS GIVING INCENTIVES TO THREE PARTIES, SO THOSE PARTIES WILL TAKE POLITICS OUT OF ENTERPRISE MANAGEMENT. FIRST, PRIVATIZATION MUST GIVE EMPLOYEES ACCESS TO

POTENTIAL CASH FLOW, SO THEY WILL NOT SEEK GOVERNMENT INTERFERENCE. SECOND, PRIVATIZATION MUST GIVE THE GOVERNMENT CASH FROM THE SALE OF A BUSINESS, SO THE GOVERNMENT WILL BE WILLING TO LET GO OF THE HELM. AND THIRD, PRIVATIZATION MUST PROVIDE INVESTORS WITH LEGAL AND REGULATORY REGIMES WHICH PERMIT THEM TO MAKE A PROFIT. ONLY THEN WILL INVESTORS PROVIDE CAPITAL AND EXPERTISE NEEDED TO RE-BUILD THE NEWLY PRIVATIZED FIRMS.

IN OUR EXPERIENCE THE FASTER PRIVATIZATION PROVIDES THESE THREE INCENTIVES THE GREATER THE POLITICAL SUPPORT FOR PRIVATIZATION. THIS EMPHASIS ON SPEED NECESSARILY MAKES THE PRIVATIZATION PROCESS IMPERFECT. BUT, SLOWER PRIVATIZATION DOES NOT ENSURE BETTER PRIVATIZATION.

II. EFFORTS TO IMPLEMENT THIS POLICY

WE HAVE PURSUED THESE POLICY OBJECTIVES ON TWO FRONTS, ONE EACH FOR PRIVATIZATION AND POST-PRIVATIZATION.

ON THE PRIVATIZATION FRONT, WE HAVE PROVIDED TECHNICAL ASSISTANCE FOR THE DESIGN AND EXECUTION OF VOUCHER AUCTIONS.

ON THE POST-PRIVATIZATION FRONT, WE HAVE PROVIDED TECHNICAL ASSISTANCE TO ESTABLISH AN ENVIRONMENT FOR NEWLY PRIVATIZED FIRMS. IN PARTICULAR, WE HAVE PROVIDED TECHNICAL ASSISTANCE

FOR THE DRAFTING OF BUSINESS LAWS. WE HAVE ALSO GIVEN SUCH ASSISTANCE FOR THE DESIGN AND ESTABLISHMENT OF CAPITAL MARKETS, TO FACILITATE TRADING SHARES AND ATTRACTING NEW CAPITAL.

WE HAVE ALSO MADE EFFORTS TO ASSIST A LIMITED NUMBER OF NEWLY PRIVATIZED FIRMS FOR DEMONSTRATION PURPOSES. SPECIFICALLY, WE HAVE SUPPORTED MANAGERIAL ADVISORS TO DEMONSTRATE HOW TO DEVELOP A RESTRUCTURING PLAN FOR A TYPICAL ENTERPRISE COMING OUT OF THE SOVIET ENVIRONMENT.

WE HAVE ALSO SUPPORTED THE ESTABLISHMENT OF EQUITY FUNDS THAT WILL PROVIDE CAPITAL, TECHNICAL ASSISTANCE, AND GOVERNANCE BOTH TO SMALL ENTERPRISES AND TO ENTERPRISES EMERGING FROM THE MASS PRIVATIZATION PROGRAM. IN PARTICULAR, THE USG HAS EIGHT FUNDS WITH THE POSSIBILITY TO DO UP TO \$2 BILLION IN FINANCING THROUGHOUT THE NIS. THESE FUNDS ARE EITHER OPERATIONAL OR IN THE PIPELINE. FIVE ARE CONGRESSIONALLY FINANCED ENTERPRISE FUNDS; THREE ARE PRIVATE FUNDS SPONSORED BY THE OVERSEAS PRIVATE INVESTMENT CORPORATION. IN ADDITION, THE UNITED STATES HAS CONTRIBUTED TO A MULTILATERAL FUND MANAGED BY THE EBRD THAT WILL SERVE MICRO AND SMALL ENTERPRISES IN RUSSIA.

ONE OF THESE FUNDS IS PARTICULARLY RELEVANT TO MASS PRIVATIZATION IN RUSSIA. IT IS THE "FUND FOR LARGE ENTERPRISES IN RUSSIA," OR "FLER," WITH CAPITAL OF \$100 MILLION. BY ESTABLISHING THE FLER, WE ALSO HELPED PERSUADE OUR G-7 PARTNERS TO SET UP SIMILAR FUNDS COORDINATED THROUGH THE "SPECIAL PROGRAM FOR RESTRUCTURING AND PRIVATIZATION," OR "SPRP." WE

UNDERSTAND THAT APPROXIMATELY SIX SUCH FUNDS WILL BE SET UP THIS YEAR UNDER THIS PROGRAM IN THE REFORMIST REGIONS OF RUSSIA.

III. PROGRAM COST

TO DATE WE HAVE INVESTED APPROXIMATELY \$86 MILLION IN THE RUSSIAN PRIVATIZATION EFFORT AND WE PLAN TO DEVOTE ANOTHER \$190 MILLION IN FY 1994 TO COMPLETE THE VOUCHER AUCTION PROCESS AND TO HELP TACKLE THE POST-PRIVATIZATION CHALLENGES THAT NEWLY PRIVATIZED FIRMS FACE.

IV. RESULTS AND SUCCESSES

THE MAIN RESULT OF RUSSIAN PRIVATIZATION IS THAT MORE THAN 50 PERCENT OF RUSSIAN INDUSTRY HAS NOW BEEN TRANSFERRED TO PRIVATE OWNERSHIP. FOR EXAMPLE, AROUND 10,000 LARGE ENTERPRISES -- EMPLOYING APPROXIMATELY 10 MILLION WORKERS AND REPRESENTING APPROXIMATELY 50 PERCENT OF LARGE ENTERPRISES -- HAVE SOLD SHARES THROUGH VOUCHER AUCTIONS. THE GOVERNMENT OF RUSSIA PLANS TO PRIVATIZE ANOTHER 20 PERCENT BY JULY 1 FOR A CUMULATIVE TOTAL OF 70 PERCENT OF LARGE FIRMS.

MANY SMALL SHOPS AND SERVICE BUSINESSES HAVE ALSO BEEN PRIVATIZED -- AROUND 100,000 AS OF APRIL. THE RUSSIAN GOVERNMENT BELIEVES THIS TOTAL REPRESENTS 80 PERCENT OF ALL SMALL FIRMS IN RUSSIA.

IN ADDITION, MORE THAN EIGHT MILLION APARTMENTS AND DWELLINGS -- ABOUT 25 PERCENT OF THE TOTAL -- WERE PRIVATIZED UNDER A JULY 1991 LAW. AND AS OF JANUARY 1994, THERE WERE ABOUT 270,000 PRIVATE FARMS IN RUSSIA, UP 50 PERCENT OVER THE PREVIOUS YEAR. IT IS BELIEVED THAT 10 PERCENT OF AGRICULTURAL LAND IS NOW IN PRIVATE HANDS, PRODUCING MORE THAN ONE-THIRD OF TOTAL AGRICULTURAL OUTPUT.

IN ADDITION, LAST YEAR OVERALL AGRICULTURAL PRODUCTION DECLINED BY FOUR PERCENT, THE LOWEST DECREASE SINCE 1991. THANKS TO A FIVE PERCENT INCREASE IN PRIVATE SECTOR PRODUCTION, THE SPECTER OF FAMINE WHICH MANY FEARED WHEN THE SOVIET UNION DISSOLVED IS FAR BEHIND US.

THUS THE LARGEST SELL-OFF IN THE HISTORY OF MANKIND IS NEARLY COMPLETE. FOR THE FIRST TIME IN 75 YEARS, RUSSIA'S ECONOMY IS NOW LARGELY PRIVATELY OWNED.

A SECOND RESULT IS OCCURRING IN THE POST-PRIVATIZATION PHASE. IN PARTICULAR, ABOUT A YEAR AFTER THEY WERE PRIVATIZED, SOME FIRMS HAVE BEGUN TO RESTRUCTURE THEIR OPERATIONS. TWO GENERAL STATISTICS FROM THE RUSSIAN PRIVATIZATION MINISTRY ARE REVEALING. FIRST, AMONG SMALL FIRMS, PROFIT HAS RISEN BY 40 TO 50 PERCENT. THE GAIN REFLECTS AN INCREASE IN PRODUCTIVITY: ON AVERAGE, SALES PER SQUARE FOOT HAVE TRIPLED SINCE PRIVATIZATION.

THE SECOND STATISTIC REFERS TO TOTAL INDUSTRY, WHERE THE DROP IN OUTPUT HAS BEEN DRAMATICALLY LESS AMONG PRIVATIZED

FIRMS. THE AVERAGE DROP FOR STATE-OWNED ENTERPRISES IS AROUND 15 PERCENT; FOR PRIVATIZED FIRMS THE DECLINE IS ONLY AROUND FIVE PERCENT.

IT IS LIKELY THAT PRIVATIZATION LED TO THESE IMPROVEMENTS, SINCE THE NUMBER OF ENTERPRISES IS SO LARGE. IT IS NOT LIKELY THAT THE ENTERPRISES CHOSEN FOR PRIVATIZATION WERE ABOUT TO IMPROVE THEIR PERFORMANCE ANYWAY.

A FEW CASES MAKE THESE IMPROVEMENTS EASIER TO SEE. FOR EXAMPLE, ACCORDING TO THE LOCAL PRIVATIZATION OFFICE IN ALTAYSKIY KRAY, FIVE FURNITURE FACTORIES HAVE IMPROVED DRAMATICALLY SINCE BEING PRIVATIZED ABOUT A YEAR AGO. SINCE PRIVATIZING, THEY HAVE INCREASED OUTPUT EIGHT PERCENT IN REAL TERMS, THEY HAVE RAISED LABOR PRODUCTIVITY 10 PERCENT, AND THEIR PROFIT IS UP FROM 13 TO 30 PERCENT.

ANOTHER CASE SHOWS THE INGENUITY OF MANAGERS THROWN INTO HARSH CONDITIONS. AT THE OPTICAL ENTERPRISE "LOMO" IN ST. PETERSBURG, PRODUCTION HAD PLUMMETED SINCE 1991, FORCING MANAGEMENT TO PREPARE FOR MASSIVE LAYOFFS. WITH THE HELP OF A U.S. CONSULTING FIRM, HOWEVER, MANAGEMENT FOUND NEW MARKETS FOR ITS ENDOSCOPES. DEPUTIZING UNEMPLOYED MEDICAL STUDENTS AS COMMISSIONED SALES REPS, THE FIRM HAS GENERATED NEW ORDERS SUFFICIENT TO KEEP 2,500 WORKERS EMPLOYED.

YET ANOTHER ENTERPRISE SHOWS THAT NEW SHAREHOLDERS CAN CHANGE COURSES AFTER MAKING BAD DECISIONS INITIALLY. AT THE

VLADIMIR TRACTOR WORKS, SHAREHOLDERS VOTED TO KEEP THE INCUMBENT MANAGER AT THE HELM AND TO REJECT A FORMER EMPLOYEE WHO HAD RECENTLY EARNED AN MBA IN THE U.S. THE INCUMBENT MANAGER RESPONDED, HOWEVER, BY DRIVING THE FIRM TO THE BRINK OF INSOLVENCY. SHAREHOLDERS THEN VOTED TO BRING IN THE AMERICAN-TRAINED RUSSIAN, JOSEPH BAKALEINIK. AS WE SPEAK, BAKALEINIK IS MOVING HIS FAMILY TO VLADIMIR FOR THIS HISTORIC EFFORT.

ONE MORE EXAMPLE DEMONSTRATES THE VALUE OF PRIVATIZATION IN ATTRACTING FOREIGN INVESTMENT. PROCTER & GAMBLE HAD BEEN TRYING FOR A YEAR TO BUY A DETERGENT FACTORY IN TULA, BUT P&G COULD NOT FIND OUT WHO HAD THE AUTHORITY TO SELL THE PLANT. ONCE THE FACILITY WAS PRIVATIZED, P&G WAS IMMEDIATELY ABLE TO BUY IT.

V. PROBLEMS

NOW FOR THE PROBLEMS, WHICH ARE WELL KNOWN TO THE PRIVATIZATION OFFICIALS IN THE GOVERNMENT OF RUSSIA. FIRST AND FOREMOST, THERE IS TOO MUCH OWNERSHIP BY EMPLOYEES. IN THE AVERAGE NEWLY PRIVATIZED LARGE FIRM, EMPLOYEES -- INCLUDING MANAGEMENT -- CONTROL APPROXIMATELY 70 PERCENT OF SHARES. THUS, OWNERS ARE OVERLY ALIGNED WITH THE INTERESTS OF LABOR AND COMMITTED TO FULL EMPLOYMENT AND NOT ENOUGH TO THE INTERESTS OF CAPITAL -- IN OTHER WORDS PROFIT FROM SALES THAT CAN SUPPORT SOLID JOBS OVER THE LONG TERM. THIS HIGH PERCENTAGE HELD BY

LABOR REFLECTS THE DIFFICULTY OF WINNING LABOR'S SUPPORT TO CARRY OUT PRIVATIZATION. UNFORTUNATELY, THIS SITUATION WILL NOW BE AN IMPEDIMENT TO THE RESTRUCTURING OF ENTERPRISES.

A SECOND PROBLEM IS THAT SOME MANAGERS HAVE PREVENTED EMPLOYEES FROM SELLING THEIR SHARES. MANY MANAGERS HAVE DONE THIS THROUGH THEIR CONTROL OF SHARE REGISTRATION. THE LIMITED CIRCULATION OF SHARES KEPT PRESSURE OFF MANAGERS TO RESTRUCTURE OPERATIONS. THE RUSSIAN PRIVATIZATION MINISTRY HAS RESPONDED BY DEVELOPING RULES FOR SHARE REGISTRATION AND A PROGRAM FOR MONITORING REGISTRATION. THIS RESPONSE UTILIZES ASSISTANCE FROM THE U.S. GOVERNMENT. THE PROBLEM IS NOT SOLVED YET, BUT PROGRESS IS BEING MADE. FOR EXAMPLE, TWO WEEKS AGO, THE SECURITIES COMMISSION IN RUSSIA PASSED ITS FIRST SET OF REGULATIONS ON HOW SHARE RECORDS SHOULD BE KEPT.

A THIRD PROBLEM IS THAT SOME MANAGERS HAVE UNFAIRLY ACQUIRED SHARES. THIS CONDITION FOSTERS RESENTMENT AGAINST THOSE MANAGERS AND THE RUSSIAN GOVERNMENT. IT IS PARTLY A CONSEQUENCE OF CARRYING OUT PRIVATIZATION BEFORE THE LEGAL ENVIRONMENT COULD MINIMIZE SUCH MALFEASANCE. HOWEVER, IT IS ONLY ONE MORE REASON TO PRIVATIZE WHILE THE GOVERNMENT STILL HAS POLITICAL SUPPORT FOR PRIVATIZATION. THE ONLY WAY TO DEAL WITH THIS SITUATION NOW IS TO STRENGTHEN THE LEGAL ENVIRONMENT, A TASK RUSSIAN PRIVATIZATION OFFICIALS ARE WORKING ON DILIGENTLY WITH SUPPORT FROM THE U.S. GOVERNMENT. WE ARE PROVIDING THIS ASSISTANCE BOTH TO THE RUSSIAN PARLIAMENT AND TO THE EXECUTIVE BRANCH OF THE RUSSIAN GOVERNMENT. THIS

ASSISTANCE COVERS A WIDE RANGE OF ISSUES, INCLUDING COMMERCIAL LAW, BANKING, SECURITIES, TAX, AND CUSTOMS REFORM.

VI. POLICY IMPLICATIONS

OWNERSHIP TRANSFER IS NEARLY COMPLETE IN RUSSIA. WHAT MUST FOLLOW NOW ARE POST-PRIVATIZATION MEASURES THAT MAKE PRIVATIZATION MEANINGFUL -- IN OTHER WORDS THAT FACILITATE THE RESTRUCTURING OF NEWLY PRIVATIZED ENTERPRISES.

THERE ARE TWO THINGS THAT MUST BE DONE. THE FIRST IS LEGISLATIVE. COMMERCIAL LAWS AND SECURITIES LAWS MUST BE DRAFTED AND INTRODUCED. THE SECOND IS DEVELOPMENT OF CAPITAL MARKETS, TO PROVIDE PRESSURE ON MANAGERS TO RESTRUCTURE OPERATIONS RATIONALLY AND ALSO TO OBEY NEW LEGISLATION. SIGNIFICANTLY, IT IS THE NEWLY FORMED SECTOR OF PRIVATE INVESTORS AND THEIR USE OF CAPITAL MARKETS -- NOT A NEW BUREAUCRACY OF THE GOVERNMENT -- THAT WILL ENSURE LEGISLATION IS ENFORCED.

AS I HAVE MENTIONED, THESE TWO MEASURES DEFINE THE CORE OF OUR POST-PRIVATIZATION POLICIES. THUS THE BEST COURSE WE CAN PURSUE IS TO STAY ON THIS TRACK. WE WILL CONTINUE TO ASSESS RUSSIAN PRIVATIZATION IN CASE OTHER DIRECTIONS ARE WARRANTED. BUT FOR NOW THE PATH TO TAKE IS CLEAR: WE NEED TO CONCENTRATE ON LEGISLATION AND CAPITAL MARKETS IN ORDER TO FACILITATE ENTERPRISE-LEVEL RESTRUCTURING, THEREBY MAKING PRIVATIZATION COMPLETE AND MEANINGFUL.

THE RUSSIAN MASS PRIVATIZATION PROGRAM IS RECEIVING 60 TO 70 PERCENT FAVORABLE RATINGS IN THE OPINION POLLS, AND THE GOVERNMENTS IN THE OTHER NIS ARE STARTING TO GET THE MESSAGE AS WELL. AT THE REQUEST OF THE GOVERNMENTS OF KAZAKHSTAN, THE KYRGYZ REPUBLIC, MOLDOVA, AND NOW UKRAINE, WE ARE ROLLING OUT OUR PRIVATIZATION ASSISTANCE TO THESE COUNTRIES WITH EXPERIENCED ADVISERS AND EXPERTS DEPLOYABLE ON SHORT NOTICE. DURING MY VISIT TO UKRAINE LAST WEEK, GOVERNMENT OFFICIALS ASSURED ME THAT THEY PLAN TO MOVE FORWARD WITH A MASS PRIVATIZATION PROGRAM THAT INCORPORATES PARTS OF THE RUSSIAN PRIVATIZATION MODEL AS WELL AS MODELS FROM CENTRAL AND EASTERN EUROPE. IN RESPONSE, WE ARE PLANNING TO PROVIDE \$22 MILLION TO SUPPORT THE GOVERNMENT'S PRIVATIZATION OBJECTIVES THIS YEAR.

A COMMITMENT TO BOLD AND COMPREHENSIVE PRIVATIZATION IS AT THE CORE OF THE ECONOMIC TRANSFORMATION UNDERWAY IN THE NIS AND THUS CRITICAL TO THE LONG-TERM DEMOCRATIC TRANSITION. AS THE PROGRAM RESULTS IN RUSSIA DEMONSTRATE, PROGRESS ON PRIVATIZATION IS AN IMPORTANT STEP TOWARD INTEGRATION INTO A WORLD BASED ON PARTNERSHIP AMONG EQUALS, WHICH WE SEEK WITH EACH AND EVERY NIS.

STATEMENT BY THE HONORABLE
LAWRENCE H. SUMMERS
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON SMALL BUSINESS
OF THE HOUSE OF REPRESENTATIVES
MAY 12, 1994

Introduction

Mr. Chairman and members of the Committee on Small Business. I am pleased to testify on the topic of privatization with a focus on the nations of Eastern Europe and the Former Soviet Union (FSU).

As you noted in your invitation to this session, Congressman LaFalce, privatization is one of the essential pillars in the transformation of these economies. It is part and parcel of the effort to empower people and to create a pluralistic society in which democracy and free markets can take root and flourish.

Lest we forget, there was a period when many believed that governments could and should manage a wide array of domestic and international economic activities. This economic ideology found its most intrusive and distortionary expression in the centrally-planned economies comprising the Soviet Bloc. But many others also participated in that ill-fated experiment.

Today, around the world, the tide has shifted. Confronted with the sad results of former policies, the state is retreating from the productive sectors of the economy, and the private sector is rushing in.

Privatization has become a major force in Latin America and elsewhere in the developing world. In Mexico, the number of state-owned enterprises has been reduced from 1,155 to less than 200. The Philippines, Malaysia, China, and Colombia among others have all planned major privatization during the first half of this year.

It is also an idea that has caught on in the industrialized nations. During the 1980s, Britain sold 30 major enterprises which employed 800,000 (civil servants) workers. Germany has announced its intention to reduce its holding in Lufthansa from 53% to 25% as soon as possible and its major state-owned saving bank, Postbank, will sell 75% of its equity beginning in 1995.

Indeed of the many economic ideas that have come to the fore in recent years -- supply-side economics, rational expectations, monetarism -- privatization will, I believe, have the most enduring importance for worldwide growth and prosperity.

Developments Throughout the Region

As we look around the region today, we see that where governments have acted with resolve, they have found a reservoir of entrepreneurial zeal and talent.

In the Czech Republic, 2,000 large enterprises now have private owners, with a second wave of 860 large enterprises scheduled for privatization in 1994. In addition, the Czech Republic and Slovakia have auctioned off more than 30,000 small businesses, and have returned 100,000 small businesses and residential properties to their former owners.

Poland's privatization of small and medium sized businesses has been hugely successful, with more than 100,000 now in private hands, and small scale privatization is virtually complete in Hungary as well.

But problems remain. For example, Poland's privatization of large enterprises remains a vexing political and economic football as various interest groups seek advantage in the mass privatization scheme first proposed in 1991. Hungary's firm-by-firm approach to large enterprise privatization has advanced at a slow pace, while scandal first tainted and then derailed a plan to sell-off 160 strategic large enterprises. We urge these countries to intensify their efforts to achieve privatization of large enterprises.

In the southern tier countries of Eastern Europe, progress has been less impressive.

Farther east, Russia has made an excellent start with its voucher privatization scheme. Indeed, the pace of privatization in Russia has outstripped that of the fastest East European reformers. This owes much to the vision of the dynamic Russian Privatization Ministry, headed by Deputy Prime Minister Anatoly Chubays.

Already, 40% of the total pool of large enterprises have been privatized. These firms employ some 11 million, 50% of Russia's industrial labor force. Also, 100,000 small businesses have been sold, 80% of the total according to Russian statistics. Russia has also made a start at land privatization -- the number of private farms rose by 50% in 1993 to total 270,000. Prime Minister Chernomyrdin recently endorsed a novel scheme for land privatization, conducted in Russia's reforming region of Nizhny Novgorod with the help of the International Finance Corporation, that, along with other models, should be extended throughout Russia to enshrine private land ownership as a basic reality.

Elsewhere in the former Soviet Union, Kazakhstan, Kyrgyzstan and Moldova are making progress. But in general, the results beyond this group have been very spotty. Our encouragement and support will be critical to advance these efforts throughout the region.

Lessons from the Experience

Mr. Chairman, there are countless lessons that I believe can be drawn from experience worldwide and in the transforming countries. Let me highlight seven.

First, the single most important lesson from the experience in Central and Eastern Europe and the former Soviet Union is that privatization works best when it commands public support and starts from the bottom up.

The government must sell privatization to the people. But commanding the support of the man on the street means successful privatization should be decentralized and start at the grass roots. It should embrace every corner of a country. It is at the local level, not the center, that the dynamism for entrepreneurial activity comes.

The quick privatization of small businesses through public auction or sale to employees is one avenue that has helped garner public support. Indeed, a thriving and competitive small business sector provides sweeping visible evidence of the benefits of market economics.

Voucher distribution programs have also engaged the public by giving citizens an immediate stake in the free market economy. Russia and the Czech Republic are excellent examples. People want to see privatized firms succeed, because then their vouchers rise in price. They carefully watch share prices movements and they time their purchases. As former Russian Finance Minister Boris Fedorov told me, the Russian people now stand in lines for several hours to buy shares, not to buy bread.

Such privatization supports democracy and rewards pluralism. But privatization also depoliticizes the state-to-enterprise relationship and does so in a way that induces managers to maximize profits. A recent World Bank study of behavior of state-owned firms in Russia shows that even the expectation of impending privatization can act as a powerful incentive to implement market-oriented managerial reforms.

Second, privatization and economic stabilization are mutually reinforcing. Governments find it enormously difficult to gain control over their budgets and monetary policies so long as they are under pressure to pump out wasteful credits and subsidies to inefficient state-owned enterprises disinterested in the bottom line.

Indeed, where privatization has progressed farthest in the region, so has stabilization. The Visegrad states are perhaps the best example. But even in Russia, where the gains in the battle against inflation have not been as great, privatization has allowed the state to sharply cut support for industry and reduce budget deficits. This reality is a key reason why the IMF is supporting Russia's 1994 economic program with a \$1.5 billion loan.

For these reasons, I reject the argument that macroeconomic stability is a prerequisite for privatization. Of course private enterprises, and state enterprises for that matter, operate better under stable macroeconomic conditions. But, as Argentina learned over many years, the wait for macroeconomic stabilization can be extremely lengthy. In fact, privatization is often a prerequisite for sustained macroeconomic stability.

Third, privatization is essential for reknitting the social safety net.

Privatization is an anti-inflation policy, and we know that inflation ravages the elderly and pensioners who live on fixed incomes. Privatization also extricates the state quickly from its financial commitments to enterprises. This frees scarce budgetary resources and allows transforming economies to concentrate them on the social safety net by targeting the truly needy, building infrastructure, and providing for education and sanitation.

A fourth lesson is that privatization is but one of many structural reforms which must take place. Concurrent progress must be realized in the overall business and legal environment. Contract law, bankruptcy procedures and tax systems must be revamped, codified, and rendered both transparent and stable if private sector activity is to blossom.

In this regard, I am reminded of a recent conversation on a plane with a U.S. businessman who was exploring opportunities in the region. The remark that stuck with me was his assertion that a signature on a contract merely signified that his client had attended the meeting. To realize the infusion of foreign capital, technology and managerial expertise that is sorely needed to modernize economies, contract law and private property must be respected and tax systems must be fair and transparent.

A fifth lesson is the clear need for what I call post-privatization assistance. Privatization changes the hands of ownership. But for firms to compete in the world marketplace, they must completely overhaul and restructure their operations.

A large number of private and newly privatized enterprises enter the competitive market environment with borderline competencies. They have a good product, but no distribution network. They have a skilled and energetic workforce, but lack product design capabilities. They have clear investment needs, but equity and long term financing for plant and equipment improvement is lacking.

In market economies, these firms would have access to a business infrastructure -- efficient banking institutions, capital markets and consulting specialists -- to address their deficiencies. In the former Soviet Union and in Eastern Europe, however, this infrastructure has yet to develop in adequate depth.

An effective, market-oriented financial system in particular could provide the lubricant needed to expand the operations of promising newly-privatized firms. Instead, lacking the expertise to evaluate risk and return, the banks choose all too often to stick with

relationships formed under central planning or seek safe havens in government securities or offshore.

Lesson six follows on this thought. Privatization should not await restructuring.

I am constantly struck to hear those who readily admit that governments are unable to operate enterprises efficiently espouse government restructuring prior to privatization. To say the least, this is not a compelling argument.

Let's think about selling a house. When you do so, it may make sense to repaint some rooms, weed the yard and patch a hole in the driveway. But who would add a swimming pool in anticipation of potential buyer desires. It is the same with the enterprises. The sensible approach is to put the assets on the market, and let the buyer, who will live with the consequences, decide what investments and alterations are required.

I think the huge success of Russia's privatization program and its sweeping effect on Russia owes much to the recognition of this basic reality by Deputy Prime Minister Chubays. It is a lesson which other countries in the region could well learn.

The final and seventh lesson is that there is no paucity of excuses for slowing the pace of privatization. I have cited two bad reasons: macroeconomic stabilization is a prerequisite for privatization; enterprises must be restructured then privatized.

But I would be remiss if I did not tackle two others.

The proposition that privatization costs jobs is not one I accept. To be sure, the evidence shows that newly privatized enterprises tend to downsize the enterprise workforce. But this fact ignores the broader reality. Privatization offers incentives for improved economic performance and it unleashes productive forces which expand economies and wealth. A competitive, expanding private sector creates employment opportunities. Indeed, I would submit that privatization is a "pro-jobs" economic policy.

There are certainly those, disenchanted by the current economic situation, who fondly recall the "I pretend to work and you pretend to pay me" attitude prevalent under the centrally planned system. But prompt, efficient privatization and a growing private sector will create rewarding, useful and productive jobs for people.

Another proposition I do not accept is that an appropriate regulatory framework must be established before privatization can go forward. It is important that the best not be the enemy of the good. Certainly, progress in the regulatory environment is desirable, but the choice is not between ideal regulation and ideal public ownership. A judgement must be made on the basis of the comparative ability to regulate privatized enterprises and to operate public enterprises. I suspect that there are relatively few cases in which continued public ownership is, in fact, the right way forward.

In short, those who would wait for ideal conditions fail to grasp the practical and psychological importance of moving promptly ahead with that which is doable.

Mr. Chairman, in your letter of invitation, you expressed concern that privatization was helping the rich and the connected, but not the average man. I share this concern. "Nomenklatura" privatization has taken place in many instances and former managers of state-owned firms have stripped enterprises of valuable assets. This can severely undermine public support for the process.

But we must also recognize that the benefits and costs of privatization will not be equally distributed to everyone's satisfaction. This is a process which excites critical reaction -- some justified and some less so.

Those countries which have approached privatization with determination are genuinely attempting to implement transparent programs which incorporate the desires of the body politic for egalitarian treatment. Public auctions, mass and voucher privatization programs, and public offerings are customarily structured to engender broad public participation in the process according to transparent rules of the game.

Let me be very clear on one matter. Neither the rich nor the poor benefits from a poorly managed economy where governments transfer large subsidies to inefficient companies. And privatization, properly organized and implemented, can be a major tool to promote economic democracy. It opens new economic opportunities to all and it gives every citizen a stake in economic well-being.

Privatization and Multilateral Support

For these many compelling reasons, privatization has been a major focus of external support for the transforming countries. My colleagues from the Agency for International Development and the State Department can best address in detail what the United States is doing through its bilateral assistance efforts to support privatization.

The Treasury Department has, however, been closely involved in two critical G-7 multilateral support initiatives for privatization. I would like to describe these for you.

The first initiative is the **Special Program for Restructuring and Privatization (SPRP)**. The SPRP was created by G-7 Heads of State at the 1993 Tokyo Economic Summit in response to a call from President Clinton. It is a \$3 billion effort, pooling the resources of bilateral donors, export credit agencies and the international financial institutions, which seeks to help large Russian firms restructure their operations.

A major focus of the initiative is to infuse equity into privatized Russian firms. Equity placements will improve corporate governance in these firms by facilitating new ownership structures and encouraging foreign direct investment, and with that, new

technologies and know-how. We believe that this equity can be mobilized and utilized more effectively at the regional level, consistent with the principle that decentralization is a key to successful privatization.

The United States is leading the international effort to mobilize equity support for the SPRP. The United States has created a \$100 million Fund for Large Enterprise Restructuring (FLER), which has already begun operations and should make its first commitments in the near future. Former Treasury Secretary Michael Blumenthal was named Chairman of the FLER's Board of Directors earlier this year.

The FLER will operate in parallel with other funds being created by our G-7 partners, customarily in cooperation with the EBRD. These regional venture funds will typically combine \$20 million of technical assistance from a G-7 donor and \$30 million in equity from the EBRD. One fund, sponsored by the European Union, has already opened in the Smolensk region. And by end 1994, seven equity funds (involving \$262 million in equity and \$108 in TA) could be created. In 1995, another five funds could be created with \$160 million in equity and \$85 million in TA.

G-7 donors technical assistance component of the SPRP will focus on privatization and restructuring. In addition, the G-7 has committed up to \$1 billion in export credits to provide restructuring firms access to needed inputs. The U.S. share of the export credit pool is \$250 million, and these exports will create jobs at home while supporting Russia's historic transformation.

The SPRP also includes loans from the World Bank and the EBRD to improve enterprise and banking sector performance. The World Bank is preparing a \$200 million enterprise restructuring loan, which will be co-financed by the EBRD (\$100 million). The Bank and EBRD will also devote \$300 million to improving commercial banks.

The SPRP is also an essential element of the G-7's efforts to help address the social consequences of privatization. It includes a \$500 million World Bank social safety net loan. We have urged Russia and the World Bank to intensify their cooperation and bring this loan to fruition.

The second initiative is the **EBRD Small and Medium Enterprise Fund (SME)**. It is a \$300 million fund, consisting of \$150 million in support from both the G-7 and EBRD. Our share is \$30 million.

The purpose of the SME is to help build small firms and an entrepreneurial base in Russia by providing technical assistance, loans and equity.

The SME has begun operations under a \$10 million pilot project in Smolensk, Tula and Tomsk. Banks in the pilot regions have received \$500,000 which is being on-lent (in projects of \$1,000 to \$50,000) to small firms.

This pilot project has worked well and it is being expanded to \$30 million. Based on this experience, we aim to work closely with the EBRD to approve the full SME project before the Naples Summit.

Conclusion

In conclusion, the transformation of the economies of Eastern Europe and the FSU offers an historic opportunity to put the Cold War behind us forever and to secure the benefits of world peace and prosperity.

Privatization is an essential part of this task. Unfortunately, there are no ironclad blueprints. But this is an endeavor which must succeed if we are to seize this opportunity. Thus, it is in our vital national interests to support privatization. Thank you.

Progress in Privatization					
Country	Large Enterprises	Small Enterprises	Agriculture	Changing Legal Environment	Comments
Moldova	<ul style="list-style-type: none"> • Vouchers distributed Fall 1993. • First auctions being organized with USG assistance. • Hope to privatize 30% of assets by end-1994. 	<ul style="list-style-type: none"> • Voucher technique for small firms, instead of cash auctions, forces investors to pool vouchers so that entire firm is purchased. • Cash only allowed for unfinished construction sites. 	<ul style="list-style-type: none"> • Private land ownership not allowed until 2000. 	<ul style="list-style-type: none"> • Some banking reform planned. 	<ul style="list-style-type: none"> • Moldova pursuing privatization as part of overall reform program. • GOM is working to accelerate the pace of privatization.
Kazakhstan	<ul style="list-style-type: none"> • 30% of assets of medium and large firms to be privatized by June '94. • In February 1994, GOK announced 38 largest firms would be sold to domestic and/or foreign investors. • Vouchers distributed November 1993. 	<ul style="list-style-type: none"> • 159 "small privatization facilities" were sold through auctions and competitive bidding in 1993. • All enterprises engaged in wholesale and retail trade, and related services, to be privatized by end-1994. 	<ul style="list-style-type: none"> • Private firms occupy only 3% of agricultural land as of early 1994 	<ul style="list-style-type: none"> • GOK announced legislation on leasing of land (which still may not be privatized). 	<ul style="list-style-type: none"> • Kazakhstan is now undertaking an ambitious privatization program, as called for under new IMF stand-by.
Kyrgyzstan	<ul style="list-style-type: none"> • Limited progress to date. 	<ul style="list-style-type: none"> • Over 4,000 small and medium enterprises privatized by November 1993. • These represented about 28% of all state assets. By end-1993, GOK was to have privatized 35% of all state assets. 	<ul style="list-style-type: none"> • 33% of agriculture privatized by November 1993. 	<ul style="list-style-type: none"> • President recently proposed legislation of land leases. • GOK is developing legislation needed in a market economy. 	<ul style="list-style-type: none"> • Good progress so far.
Tajikistan	<ul style="list-style-type: none"> • Unclear. 	<ul style="list-style-type: none"> • Some private service and export-import firms have been privatized. 	<ul style="list-style-type: none"> • Extensive private sector based on family plots and long-term leases. • Supply and transportation systems remain state control. 	<ul style="list-style-type: none"> • Little progress. 	<ul style="list-style-type: none"> • Limited progress; very difficult internal and external situation.
Turkmenistan	<ul style="list-style-type: none"> • GOK wishes to continue control over critical sectors for several years. 	<ul style="list-style-type: none"> • No figures available. 	<ul style="list-style-type: none"> • 5% of arable land privatized by December 1993. • Presidential announcements have not been implemented. 	<ul style="list-style-type: none"> • Unclear. 	<ul style="list-style-type: none"> • Limited progress. GOK continues to play major role in economy.
Uzbekistan	<ul style="list-style-type: none"> • Limited progress to date. 	<ul style="list-style-type: none"> • Privatization initiated, but numbers are not available. 	<ul style="list-style-type: none"> • Progressing rapidly. 	<ul style="list-style-type: none"> • Unclear. 	<ul style="list-style-type: none"> • Progress being made. • Privatization needs to be backed up with commitment to macroeconomic stabilization

Progress in Privatization					
Country	Large Enterprises	Small Enterprises	Agriculture	Changing Legal Environment	Comment
Russia	<ul style="list-style-type: none"> 150 million citizens given vouchers; most have been used in auctions or placed with investment funds. Shares sold via auctions in 10,000 firms (70% of those slated to be privatized by this method or around 40% of all large firms). 11 million industrial workers (50% of industrial work force) in these firms. Voucher privatization to end 7/1/94. Post-voucher privatization on cash basis only. 	<ul style="list-style-type: none"> Around 100,000 small retail and service businesses privatized on a cash basis, usually to current employees/managers. GOR claims this is 80% of the total. 	<ul style="list-style-type: none"> As of January 1994, there were 270,000 private farms, 50% more than a year earlier. On 10% of agricultural land, private farms and family plots produce almost 40% of agricultural output. GOR is introducing land privatization based on IFC model introduced in Nizhny Novgorod in late 1993. As of October 27, 1993, sale, purchase, lease and mortgage of land is permitted. 	<ul style="list-style-type: none"> Progress in changing legal environment has lagged. Financial system unable to offer long-term financing. Taxation is often arbitrary and onerous. Shareholders often unable to wield their rights. Bankruptcy legislation has not been applied. 	<ul style="list-style-type: none"> Privatization has been very impressive. Program has largely changed ownership, but firms need to be restructured – both in terms of management and operations. While this is beginning, there is much work to be done. Progress on macroeconomic stabilization will reinforce privatization.
Ukraine	<ul style="list-style-type: none"> Non-transferable vouchers in Savings Bank have been issued, but not yet used; privatization limited to special cases. Little progress on plan to privatize 8,000 firms in 1994. 	<ul style="list-style-type: none"> IFC-led pilot cash auctions for cash taking place in nine regions. Little progress on plan to privatize about 20,000 small firms in 1994. 	<ul style="list-style-type: none"> Some leasing of land permitted. No clear plans for privatization. 	<ul style="list-style-type: none"> GOU has signed trade, tax and investment treaties with USG. Little real improvement in legal environment which impedes foreign investment. 	<ul style="list-style-type: none"> Privatization has not made much progress in Ukraine than other FSU states. Effort to date hindered by political factions and macro instability.
Belarus	<ul style="list-style-type: none"> Vouchers to be distributed this summer. 	<ul style="list-style-type: none"> IFC-led pilot project in Brest. Limited prospect for expansion in cash auctions. 	<ul style="list-style-type: none"> Some leasing, but no plans for privatization. 	<ul style="list-style-type: none"> GOU has signed the trade and investment treaties with USG. Legal framework is unchanged. 	<ul style="list-style-type: none"> GOU has made limited concrete progress to date.
Armenia	<ul style="list-style-type: none"> Process cumbersome; parliamentary approval needed for any privatization. 	<ul style="list-style-type: none"> Progress evident, but limited information on quantity of privatization. 	<ul style="list-style-type: none"> Almost all arable land privatized. 	<ul style="list-style-type: none"> Little apparent progress. 	<ul style="list-style-type: none"> Agricultural privatization has led to efficiency gains. Need to improve administrative structure for other types of privatization.
Azerbaijan	<ul style="list-style-type: none"> No progress. 	<ul style="list-style-type: none"> Little apparent progress. 	<ul style="list-style-type: none"> No progress. 	<ul style="list-style-type: none"> Despite attempts to attract oil sector investment, little change evident in legal environment. 	<ul style="list-style-type: none"> Limited privatization.
Georgia	<ul style="list-style-type: none"> No progress. 	<ul style="list-style-type: none"> Some progress. 	<ul style="list-style-type: none"> 15-40% of arable land privatized. 	<ul style="list-style-type: none"> Little progress. 	<ul style="list-style-type: none"> GOG has undertaken very modest effort so far.

Progress in Privatization

Country	Large Enterprises	Small Enterprises	Agriculture	Changing Legal Environment	Comment
Czech Republic	<ul style="list-style-type: none"> About 2,000 larger enterprises were at least partially privatized in "first wave" ending in 1993 (including using vouchers to partially privatize 988 enterprises). 861 larger enterprises are being at least partially privatized in "second wave" of voucher privatization in 1994. 	<ul style="list-style-type: none"> About 22,000 shops and small businesses were privatized in weekly auctions. About 70,000 former owners of nationalized residential and commercial properties and small businesses regained their properties under restitution program. 	<ul style="list-style-type: none"> Only half of 1,000 state farms scheduled for privatization have actually been privatized. Unsolved restitution claims are delaying remaining farm privatizations. 	<ul style="list-style-type: none"> Significant progress, e.g., modern bankruptcy law (with Chapter XI provisions) enacted. Remaining problems: slow commercial court system, inadequate creditor rights to seize collateral. 	<ul style="list-style-type: none"> Rapid development of new small businesses. Most rapid progress on larger privatizations in Eastern Europe. Good progress on creating favorable legal environment.
Slovakia	<ul style="list-style-type: none"> About 750 larger enterprises at least partially privatized in "first wave" ending in 1993 (including 503 enterprises partially privatized through vouchers). 519 larger enterprises to be at least partially privatized in "second wave" between end-1994 and 1995 (including about 45% through voucher privatizations). 	<ul style="list-style-type: none"> About 9,400 shops, small businesses and residential buildings were privatized in weekly auctions. About 30,000 former owners of nationalized residential and commercial properties and small businesses regained their properties under restitution program. 	<ul style="list-style-type: none"> Private sector accounts for 11% of land, cooperatives for 66%. Further progress is hindered by lack of clear title on old properties, since primegeniture system was not used, and WWII and subsequent communist regime destroyed old land ownership records. 	<ul style="list-style-type: none"> Significant progress, e.g., modern bankruptcy law (with Chapter XI provisions) enacted. Remaining problems: slow commercial court system, inadequate creditor rights to seize collateral. 	<ul style="list-style-type: none"> Relatively good development of new small businesses. Good early progress on privatization before mid-1993. Govt. wants to speed up large privatization. Good progress on creating favorable legal environment.
Hungary	<ul style="list-style-type: none"> Privatization of large scale enterprises has proceeded slowly. Holding company (ANYT) that was to manage, restructure and eventually sell 160 of Hungary's "strategic" enterprises was disbanded. 	<ul style="list-style-type: none"> Small scale privatization has been highly successful, and privatization of shops and restaurants is virtually complete. Over 10,000 shops were sold to private entrepreneurs. 	<ul style="list-style-type: none"> About 20% of land is in private farms; 55% in cooperatives; 25% in private hand in 3-5 years. 	<ul style="list-style-type: none"> Modern bankruptcy law took effect in 1992. 	<ul style="list-style-type: none"> Good progress on creation of new private sector businesses and on small privatization. Slower progress on large privatization, in absence of mass privatization program. Good progress on creating legal infrastructure for private economy.
Poland	<ul style="list-style-type: none"> Privatization of large enterprises delayed pending implementation of mass priv. scheme; only 367 of 600 have signed up. National investment funds slowly being formed. 1,700 of 6,000 medium and large scale enterprises privatized through liquidation track. 	<ul style="list-style-type: none"> Privatization small enterprises proceeded much more quickly. Estimated 100,000 small and medium sized retail and wholesale outlets have been privatized. Privatization of existing state-owned shops largely completed through public auction. 	<ul style="list-style-type: none"> About 80% of the agricultural sector is in private hands, much of that pre-dating 1989. Privatization of state farms going slowly in part because of lack of finance and in part because the agricultural sector is not highly profitable and therefore the demand for agricultural land is weak. 	<ul style="list-style-type: none"> Commercial code and accounting standards generally brought into line with those in Western Europe. Foreign investment law revised in 1991; US has ratified bilateral investment treaty; Poles close to ratifying and it will then enter into force. Anti monopoly legislation introduced but not yet passed; Property rights and title to property still needs to be dealt with. 	<ul style="list-style-type: none"> Private sector vibrant element in economy; 1993 4.5 % growth due entirely to increased private sector output. Private sector shifting composition of output away from heavy industry to retail and services, areas long neglected by Communist regime. Mass privatization of large enterprises proceeding slowly due to concerns about social safety net issues.

Progress in Privatization				
Country	Large Enterprises	Small Enterprises	Agriculture	Changing Legal Environment
Bulgaria	<ul style="list-style-type: none"> 13 large enterprises (valued at 10 million leva or more) have been privatized under the Privatization Agency since 1992. 	<ul style="list-style-type: none"> About 30,700 buildings and small shops have been privatized through restitution process (representing 50% of claimed value). In addition, 105 privatization transactions involving small and medium-size enterprises completed by branch ministries since 1992. Mass privatization scheme designed to spur privatization of small and medium-size enterprises awaiting parliamentary approval. 	<ul style="list-style-type: none"> Through restitution process, 43% of total land, or 5.1 million hectares, returned to original owners. Land restitution is going slowly because of fragmented land ownership prior to communism. By returning to originally subdivided plots, process recreates uneconomical landholdings, thus forcing new producer cooperatives. 	<ul style="list-style-type: none"> Lack of bankruptcy and liquidation laws and procedures.
Romania	<ul style="list-style-type: none"> Program to privatize 30 large enterprises awaiting implementation. 	<ul style="list-style-type: none"> 244 of the 550 targeted small and medium enterprises were privatized in 1993. About 2,000 enterprises are targeted for privatization in 1994. 	<ul style="list-style-type: none"> Most cultivated land is in private hands, as former landowners regained land from cooperatives or received shares in corporatized state farms. Most animal products produced by private farmers. 	<ul style="list-style-type: none"> Proposed modern bankruptcy law has not yet been enacted, and no legal framework exists for mass privatization.
				<ul style="list-style-type: none"> Privatization of enterprises and commercial banks has gone slowly.
				<ul style="list-style-type: none"> Privatization and other structural reforms have lagged efforts elsewhere in Eastern Europe.



U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

June 21, 1994

*The Deputy
Administrator*

The Honorable John J. LaFalce
Chairman
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing to thank you for the opportunity to appear before your Committee on Small Business on May 12, 1994, to discuss "Privatization: The Goals and Implementation of U.S. Policy" and the U.S. Agency for International Development's (USAID) role. I request that this letter be made part of the record of that hearing.

There are two points made in my testimony that I would like to underscore. First, this Administration shares your concerns regarding social and equity issues related to privatization and structural adjustment. Secondly, the leadership of this Agency is taking steps to mitigate the social costs of economic and political transformation. We want to support developing country reform processes that result in broader, more equitable economic and social participation by the people.

We support structural adjustment, including privatization, where appropriate, because a policy and institutional environment that supports rather than discourages productive investment and growth is an absolutely critical element to healthy and sustainable development.

In some countries where policies have become badly distorted or public institutions ineffective and costly, major reforms are necessary, often including privatization of state-owned enterprises. However, because privatization may exact short-term costs, we at USAID are sensitive to the need to mitigate, where possible, the effects of these costs on the most vulnerable groups in society.

Gaining public support in the New Independent States (NIS) and Central and Eastern Europe (CEE) is essential for successful

transition to free markets and democratic governance. People must believe that reform will produce improvements in their economic and social circumstances. Today, however, many households throughout the regions are facing hardships as overstaffed and non-competitive state enterprises are forced to retrench. Workers are not only being cut off from their incomes, they are also losing access to housing, health care and education.

USAID is committed to helping build a free-market system of productive enterprises creating the wealth that can assure a more prosperous and equitable future. U.S. assistance is therefore directed primarily at supporting the economic transition. In FY 1994, approximately \$350 million will support privatization programs in CEE and the NIS. An additional \$100 million funds initiatives that foster new business development; and another \$340 million is dedicated to programs such as health care, food for work programs, housing finance and development of local non-government organizations, to mitigate the social impact of transition.

Social gains of privatization and other reforms include higher overall employment, increased wage levels, and a more efficient, dynamic and expanding economy. However, in the short term, the most immediate, visible and direct impact can be labor force downsizing, particularly for public and parastatal employees who lose income as economic decisions become more an affair of the market than of government.

USAID is working throughout the world with other donors and host countries to mitigate these short-term effects. We support affordable severance payments schemes, unemployment benefit programs and temporary public works programs to ease the impact of labor layoffs.

- In the late 1980's we supported a public-works program in Tunisia, funded in part by local currency generated from the sale of P.L. 480 agricultural commodities, and, with the World Bank, developed a severance pay system for laid-off workers.
- Similarly, in El Salvador local currencies were used for severance pay to workers laid off from the grains marketing parastatal following its privatization.
- In Nicaragua, USAID tied release of foreign exchange for budget support to reductions in the civil service. Through a voluntary program, the government reduced its rolls by 27,000 people by offering severance pay from its own resources.

I share your concern for the implications for employment and equity that are associated with structural adjustment and privatization. In this regard, I would like to bring to your attention USAID's report, "Strategies for Sustainable Development," which reflects this Administration's policy for development assistance. We believe a growing world economy is critical to U.S. interests and even more vital for low-income countries. Without it, our investments in health and education will not be sustainable and our efforts to reduce poverty will founder. With growth, we not only help poor people, we also expand our own trade and investment opportunities.

Specifically, USAID's strategy for broad-based economic growth focusses on three areas: strengthening markets, investing in people, and expanding access and opportunity. We are paying particular attention to those less advantaged by promoting microenterprises and small businesses, enhancing food security, and increasing women's access to employment, land and capital. In all our programs we emphasize broad participation and development of local capacity. Our overarching concern is whether there are improvements in people's lives. For example:

- The Administrator has started an Agency-wide Microenterprise Initiative bringing microenterprise development into the mainstream of USAID's economic growth activities.
- We are beginning a \$12 million microenterprise program in the NIS, working through U.S. nongovernmental organizations to help up to six geographic areas. Voluntary organizations are already working with women artisans and microenterprises in Russia. Land O' Lakes is working with us to train women dairy farmers in Albania, Estonia, Latvia, Lithuania, Poland, Slovakia, Romania and Bulgaria.
- In Morocco, Tunisia, Zambia and Egypt, USAID was the first donor to promote Employee Stock Ownership Plans (ESOPs) -- a mechanism that broadens participation and enhances equity.
- Agency-wide, we are stressing basic education, particularly programs which target girls, because each additional year of schooling increases their earning potential dramatically.

The Agency is also actively working to inform our policies. For example, the Agency commissioned a study entitled, "Mitigating the Social Impact of Privatization." USAID also chaired the U.S. delegation to the UNCTAD Working Group on Privatization, participating in four symposia: mitigating the social impact of privatization; promoting transparency and broad citizen

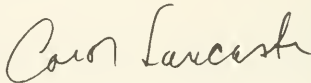
involvement in privatization; developing effective anti-trust legal regimes and regulatory institutions; and using mechanisms which encourage equity and broad participation. As stated in my testimony, we succeeded in gaining the endorsement of the delegates from 70 countries to address social impact and support measures in this forum.

We have been particularly active in looking at the impact of privatization and other reforms on the poor in Africa. Recently, USAID commissioned Cornell University to study poverty and reforms in Adjusting to Policy Failure in African Economies. The study covers ten countries and concludes that certain reforms are more likely to help the poor than hurt them. This is particularly true for rural areas which contain 80-90 percent of the poor. With respect to civil service reform, the study helped us understand why laid-off government employees in Ghana found new work very quickly, while in Guinea that was not the case.

Through these efforts the Agency is committed to making the painful adjustments we support more people-conscious and directed to helping the greatest number of people.

I assure you that your thoughtful concerns with the social and equitable implications of privatization are shared by this Agency. Your timely hearings have contributed to our thinking on these important matters.

Sincerely,



Carol Lancaster

Enclosures:

1. "Strategies for Sustainable Development"
2. Mitigating the Social Impact of Privatization (Draft)
3. Adjusting to Policy Failure in African Economies

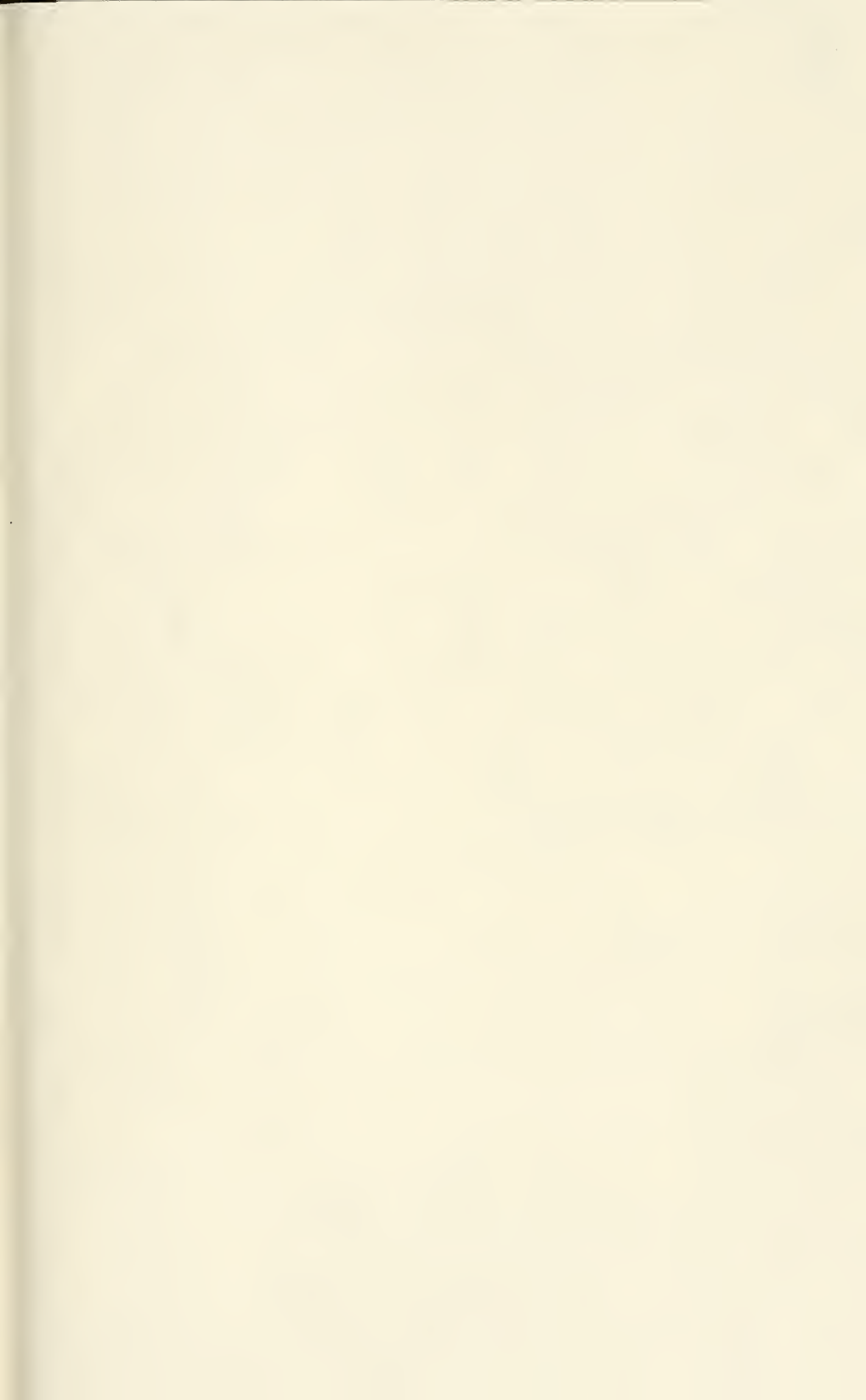




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